JANUARY 1958

VOL. XXVIII NO. 1

THE NEW YORK Certified Public Accountant

ublished monthly by
New York State Society
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THE NEW YORK

Certified Public Accountant

VOL. XXVIII *January* • *1958* No. 1

Society and Editorial Offices: 677 Fifth Avenue, New York 22, N. Y.

Accounting News And Trends

Canadian Standards of Disclosure

Standards of disclosure in financial statements for the accountants of Canada are set forth in Bulletin No. 14 of the Canadian Institute of Chartered Accountants (*The Canadian Chartered Accountant,* September 1957). Certain aspects of this bulletin may be of interest to American CPAs.

The financial statements should be read as a whole and notes appended thereto are considered to have the same significance as if the explanations were placed against the items concerned. It is suggested that the wording of the items contain references to the notes to emphasize the fact that they are part of the financial statements.

The basis of valuation of inventories should be clearly disclosed. If the method of determining cost has resulted in a figure which does not differ materially from recent cost, then the simple terms "lower of cost or market" or "cost" are suitable. Otherwise, as in the case of LIFO, the method of determining cost should be disclosed. Any change in the basis of valuation from that of the previous year and the effect of the change on the net income for the year should be fully disclosed.

The accounting practice followed with respect to the profits or losses of non-consolidated subsidiaries should be indicated. Disclosure should be made of the amount of the increase or decrease in the parent's equity in its non-consolidated subsidiary companies since acquisition and also for the year under review as a result of profits, losses and dividends, to the extent that such amount has not been taken into the accounts of the parent company.

A consolidated statement should be presented wherever it is likely to present the most informative view. In some cases, adequate disclosure may not be furnished by the submission of consolidated statements only, and in such cases separate statements for the more important constituent companies (as well as the consolidated statements) should be submitted. Where one or more subsidiaries are not included in the consolidation, the reason for exclusion should be clearly stated.

Rotating Bank Accounts

Hundreds of thousands of man hours spent by American industry in preparing monthly bank reconciliations can be saved if the suggestions made by Charles J. Gansloser in the *L. R. B. & M. Journal* (April-June, 1957) are followed. In his article "The Rotating Bank Account" the author points out that this saving could be accomplished by opening a new bank account each month through the transfer of the book balance of the old account. Both accounts, of course, would be in the same bank and provision would be made for the automatic opening of these monthly accounts.

The outstanding checks and deposits in transit in the closed account should clear rapidly and the bank statement

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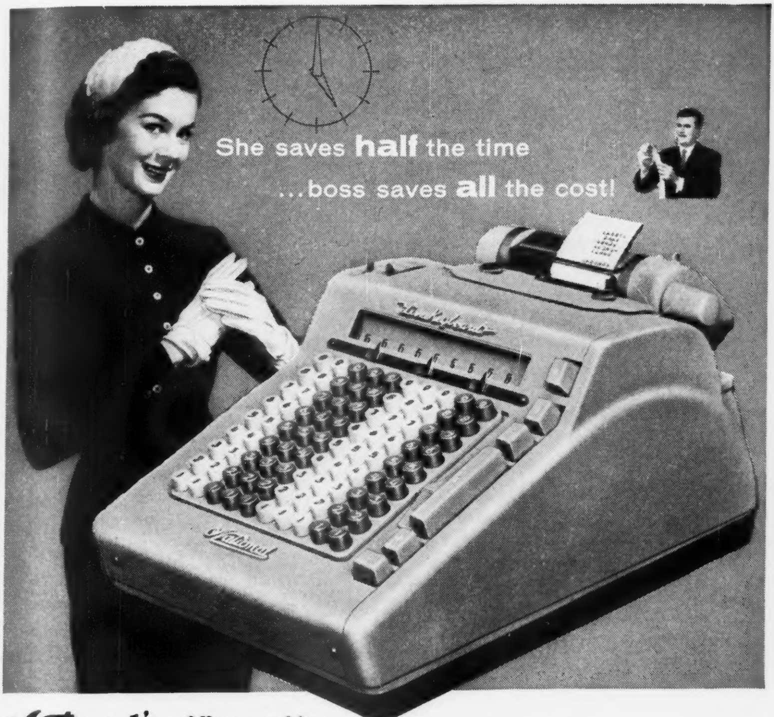
ACCOUNTING NEWS AND TRENDS *is conducted by* CHARLES L. SAVAGE, C.P.A. *and member of the New York Bar. He is presently serving as chairman of our Society's Committee on Members in the Field of Education.*

Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College.


She saves half the time
...boss saves all the cost!

would soon reveal a zero balance, probably in 2 or 3 months. The author believes that a blanket authorization by the Board of Directors of a company would probably meet the bank's requirements for opening and closing monthly accounts. An informal survey of several banks revealed an active interest in such a plan. Indeed, some of the banks cited cases where a few of their customers already use such a system or a variation of it.

In implementing such a system it would be necessary to definitely identify the checks for each month either by colors or by prominently printed code numbers so that the canceled checks can be quickly related to their respective accounts. The use of this rotating bank account procedure would require no different accounts in the general ledger. The month-end balance in the cash account, which represents the amount to be transferred to the new account, would require only memorandum entries in the cash disbursement records. Under such a system, the author suggests, it will usually not be necessary to perform three time-consuming steps when reconciling bank statements. The omitted steps are:

1. Sorting the canceled checks in numerical sequence.
2. Comparing canceled checks against the check register to determine outstanding checks.
3. Preparing a list of outstanding checks.

Enforcement of Bulletin No. 23

It is anticipated that the membership of the AICPA will vote favorably on the matter of the inclusion in the rules of professional conduct of the principles of reporting reflected in Statement on Auditing Procedure No. 23. Indicative of the growing trend toward enforcement of the Bulletin is a recent action

of the Board of Directors of the Oregon Society of CPAs (reported in *The Oregon CPA*, December 1957). After a special hearing, a member was found guilty of non-compliance with Statement No. 23 and was suspended from membership in the Society.

Reporting on Internal Control

Using a negative example to illustrate that reports should always take the positive approach, Mr. Patrick Collins ("Internal Control: Considerations In Testing And Reporting," *The Arthur Young Journal*, October, 1957) offers the following on how *not* to report on internal control to management:

"During the course of our examination, the following matters which came to our attention are, we believe, worthy of your consideration:

1. Petty cash fund ($25 in amount) is left unattended during the lunch period.

2. Receipts from gum machine are not removed in the presence of a second person.

3. The cashier maintains the accounts receivable ledger and the sales journal.

4. Receiving reports are not prepared when material is received and payment of invoices is made without any check as to the actual receipt of merchandise covered by the invoice.

5. The stamp fund was short two dollars at the time of our cash count.

6. In our review of payroll and personnel records it was noted that the cashier had not taken a vacation in seven years."

Obviously, the inclusion of items 1, 2, and 5, shows poor judgment because they may cause the reader to overlook the serious defects revealed by the other items. This letter exemplifies the negative approach because it fails to explain the risks involved or to make any recommendations as to corrective procedures.

An Adirondack View

Snow falls upon the just, and the unjust feller; but chiefly upon the just—the unjust has his umbrella.

And snow does other things besides fall. Down in that city, where world finance centers, it creates confusion—almost chaos. In December it took one commuter as long to get to her home in Jersey as it took her a week later to get to Jamaica (West Indies, not Long Island).

But upstate, especially in the mountains, we like snow. We push it off the roads into banks on the sides, and then we use these snow banks to stop us safely when we skid some later slippery day. Sometimes snow banks are more useful than national banks.

Furthermore, if we want to have plenty of water next summer, we need snow up here in the winter. Snow is inflated water, like money is concentrated work. And water is not only a beverage, but economically it is real wealth. It is stored in ponds, then dropped thru the turbines to produce power, income for wage payments, profits for dividends, dividends for college operation, students for scientists, then who knows — perhaps a whole string of satellites chasing each other around Mother Earth!

Well, when snow comes we know that a new year arrives too. So, for each of you, we say to all the rest of us, may you and yours have a good New Year.

LEONARD HOUGHTON, CPA
Saranac Lake Branch of
"The Adirondack Chapter"

Letters to the Editor

Determination of Fees and Clients' Ability to Pay

In connection with determination of fees, the question whether ability to pay should be considered, has been asked over and over again.

Ability to pay is considered in connection with wealthy clients, with currently prosperous businesses, and in connection with clients with limited means and currently poor businesses. In most of the older professions the wealthy clients or patients are charged higher fees for services rendered than the poorer clients or patients. A good example is a fee charged by a surgeon for an operation. For exactly the same kind of an operation, a surgeon would usually charge a much higher fee to a wealthy person than he would charge to a person with only a modest income. Similarly in our profession, our rates should not be rigid. Our rates to wealthy clients with prosperous businesses should be above our normal rates, and the normal rates should be, of course, charged to clients with normal or average means. This procedure will enable us to favor, occasionally, some of our old friends, clients who are presently less fortunate in business, with slightly lower rates. We will thus be still earning, on the average, a fair professional income and, at the same time, we will be serving our community in a fair, professional, and equitable manner.

There are, in addition to the above, two types of cases which must be considered relative to this question.

1. In connection with a good, old client whose business is temporarily poor; or

2. In connection with a new client whose business prospects are good but slow in developing.

In both cases, however, the fees should always cover the salaries and overhead. The slight temporary reduction should only apply to the accountants' earnings in excess of costs.

In addition, these clients should be told that their fees are below normal and that there will have to be an adjustment of fees as soon as the business will improve. Very frequently, this adjustment of fees does not only apply to the future. Many fairminded businessmen agree to carry these adjustments also to the past.

JACK GOLDNER, CPA
New York, N. Y.

The Reluctant Specialist

One phase of industry specialization in public accounting that did not come up in the interesting discussion at the November general meeting of our Society, was that of the reluctant specialist.

Usually it is not the accounting practitioner who selects the client, but the client who selects the public accountant. We find that most clients come from recommendations of other clients and also that businessmen in the same industry tend to know each other. Because as true general practitioners we will usually accept any accounting work offered to us (provided that it is not illegitimate or unethical), there is a tendency for many of our clients to fall into a few definite industries or types of work.

Industry specialization offers many advantages to the client based on greater efficiency and technical knowledge. If the practitioner continues to do general work and maintains a reasonable interest in professional matters, the danger of a narrow viewpoint would be minimized. For the accountant, the obvious

advantage is the expansion of clientele.

But there are very definite reasons why accounting firms prefer diversified practices. It is sometimes more difficult to obtain competent staffmen. Training assistants is harder because we find clients do consider specialization by an accountant an advantage, and, in turn, expect a great deal more technical knowledge.

If an accountant were to lose a client in a closely knit industry, more of his other clients would hear about it than if the clients were unknown to each other.

A final reason that may make an industry specialist reluctant to confine his practice to the industry is that so many of his eggs are in one basket. If that industry should go into a temporary decline, he may find his practice in financial difficulties.

LOCKE GRAYSON, CPA
New York, N. Y.

Roll-On, Roll-Off and Cost Accounting

It is a truism to state that accountants are constantly alert to new industrial developments particularly to the extent that there are accounting implications. For this reason, I felt it appropriate to address this letter to *The New York Certified Public Accountant* to aquaint its readers with a development originating in Hawaii, which may have later reflections on the U. S. mainland.

Cost accountants throughout Hawaii are beating a tattoo on their comptometers since it was suggested to them recently that cargo which now costs about $7.50 a ton to move between ship and shore can be handled for about 17 cents a ton, with further saving on pilferage, claims, packaging and other items, by the inauguration of lift-on, lift-off steamship service between Island ports and the American Pacific Coast. Widespread interest in this proposal is natural since the cost of surface freight

affects directly every commercial and industrial activity in the Territory.

Senator Benjamin F. Dillingham, Vice President and General Manager of the Oahu Railway and Land Company, discussed the project at a meeting of the Hawaii Chapter, National Association of Cost Accountants. His company, which pioneered railroading in the Islands when Hawaii was a monarchy and now operates extensive terminal facilities and railway marshalling yards at Honolulu in connection with its steamship agencies and an inter-island barge service, has been investigating the potentials of roll-on, roll-off and lift-on, lift-off vessel service for some time. He sees the possibility now of inauguration of the latter type of freight handling here within the next 12 months.

Initially, the company's interest centered on roll-on, roll-off service, with specially built ships, costing around $15 million each, that would, in effect, bring American transcontinental railroad terminals westward from the Pacific Coast to Honolulu harbor. Mr. Dillingham upon the authorization of the company's directors made an exhaustive examination of the potentialities of this type of service and has reached the conclusion that some form of containerization, in which cargo in specially designed containers is either lifted on and off or rolled on and off specially designed vessels or barges, is the most practical approach to the problem. Ships for a lift-on, lift-off operation could be acquired and converted for about $4 and a half million each. Barges for a roll-on, roll-off operation could be acquired for about $2 million. In either instance, substantial savings could be effected, not only in terms of handling the cargo and containers but through a speed-up of the turn-around of vessels in port. Terminal improvements to accommodate the containerized operation at the Honolulu and West Coast ends would probably not exceed $3 million or $4 million.

Despite these substantial outlays in capital requirements, together with the cost of building containers, the over-all savings would more than offset such expenditures.

Mr. Dillingham has been in frequent conference during the past year with government authorities, mainland railroad and port officials and with steamship representatives, including those of the Matson Navigation Company, which presently handles a major portion of Hawaii's freight transport and surface passenger travel. There are still many details to be worked out if the service is to be undertaken. However, in the opinion of Mr. Dillingham there is no insurmountable obstacle to its realization in the very early future.

CHARLES E. HOGUE
Honolulu, Hawaii

Aspects of Independence—Foreign and Domestic

I must assume that it is only with "tongue-in-cheek" that you print without official comment of your own, a review of an item by K. L. Milne in *The Chartered Accountant in Australia,* titled "Independence—The Broader Concept" and to which you attach your own title "Aspects of Independence" in the *Accounting News And Trends* Department, issue of July 1957.

What struck my instant attention was this paragraph: "When an accountant is asked to perform work on a permanent basis for a competitor of a present client, he should ask the latter's permission before undertaking the engagement. It would also be appropriate to notify the prospective client of his current work for a competitor in case the client would prefer seeking another accountant. If all agree and the engagements are commenced, it is of utmost importance that each client's affairs be kept with the strictest confidence and completely apart . . ."

In our own practice of over 45 years, we have, at one and the same time, audited as many as 40 or 50 firms in the same line of business. Never have we asked the permission of any firm whether we should take on a competing firm. Many such competitors are in the same building, often on the same floor. It is nothing for our staff men to make their monthly interim checkup of one firm in the morning, and of a competing firm in the afternoon. In fact, we schedule audits that way because of convenience.

This question has, of course, nothing to do with the impropriety of an accountant taking on a case already being handled by another accountant. The latter ethical aspect is correctly handled in the professional rules of conduct. What I am sticking to is the right of an outside independent accountant to take on any engagement even if it be an offer by a current client's competitor.

It has been our experience that satisfied clients, meeting their competitors at trade shows and conventions and comparing notes, will recommend their accountants. Of the thousands of accounts we have handled in these years, I would say that more than half emanated from recommendations by other accounts in the same lines of business. We wouldn't dream of asking an account whether we

should take on a competitor. Nor do we even tell the former. We take them both on, and that's that. Oh, yes, maybe forty years ago, one account objected to our working for a competitor, and flatly demanded we give up the latter. We showed the first account that we had been working for his competitor for almost a year, and in the same way that we had not told him about his competitor engaging us, we had not told the latter either. We kept both accounts—in fact we expanded these to about forty firms in the same line.

Were accountants generally to sacrifice their independence by asking permission from one client to take on a competitor, then where is the precious experience and specialization to come from? Can you visualize accountants having among, say 100 accounts, one only of each type of business—one cloak-and-suiter, one dress house, one shoe house, one furrier, one egg house, one chicken market, one kiddie shop, etc.? Accountants know that when they have many clients in the same line of business, all of their clients benefit from this, because any good things learned about office administration and accounting procedure in different offices will be utilized for the benefit of all, and any client who objects to that should be resigned from at once.

Just as a doctor does not discuss his patients' ailments, nor even disclose the names of his patients, so accountants do not disclose intimate information about clients. They do talk shop, of course, just as lawyers do, but of the technical problems involved, never of the personal matters. . . .

I do wish you would develop further discussion on this topic. I strongly disagree with the item which caused this letter to be written.

CHARLES LIPKIN, CPA
New York, N. Y.

Classified Section

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CPA, age 33, 14 years diversified public accounting and tax experience, seeks supervisory position with potential growth. Box 1309.

CPA, 20 years diversified public accounting experience will service accountant's clients up-state New York, daily or job basis. Box 1310.

Assistant Comptroller, CPA, law degree, presently employed, seeks better opportunity, over 25 years diversified experience, public and private, office management, financial statements, internal controls, credits and collections, taxes. Box 1311.

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Tax Attorney, female, ten years with CPA firm, experience research, preparation returns, protests, Federal, State, local, $6,500. Box 1313.

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CPA, 10 years diversified experience, available on per diem or job basis, will also service accountants out-of-town clients. Box 1315.

CPA, 30, 9 years diversified experience, wishes to establish sincere, mature relationship with firm or practitioner for purpose of acquiring interest. Box 1328.

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DUCKS REALLY GROW
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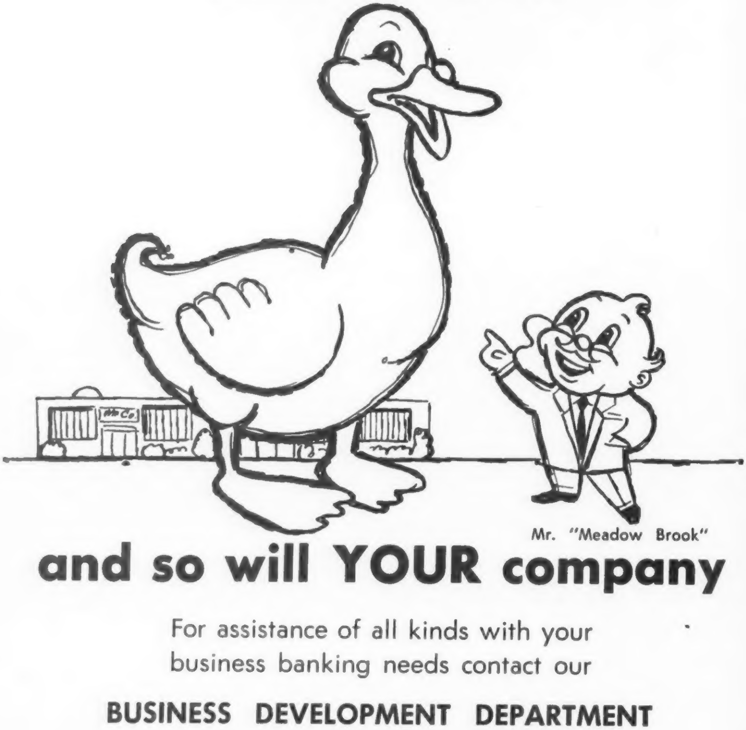

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Life Insurance Planning

By Doris L. Bosworth, C.P.A.

Proper life insurance planning can do much to relieve a client of certain business and personal problems. The CPA is in a favorable position to suggest the benefit to be derived from a careful consideration of the personal, business and tax aspects of life insurance.

With the growth of our economy has come increased recognition of the importance of the accountant both in his professional and technical accounting role and for his ability to render substantial guidance in the management of business and financial affairs.[1] Life insurance planning is an excellent illustration of the opportunities available to the accountant for such guidance. Although it is a field requiring the services of many specialists, including attorneys, insurance planners and trust advisors, the accountant in the course of his regular audit, is in an especially favorable position to call attention to the benefits to be derived from a proper life insurance program. A condition to such guidance, however, is a knowledge of the general forms of life insurance and their advantageous employment, both in the operation of a business and for the benefit of the executives. In considering the merits of a program designed to meet the needs of a particular fact situation, all phases including taxation must be taken into account. Once the need for insurance has been established it will then be necessary to seek the advice of each group of specialists required to accomplish the desired goal.

Doris L. Bosworth, C.P.A. *and member of our Society, is on the staff of Peat, Marwick, Mitchell & Co., Certified Public Accountants.*

Ordinary Life Insurance

Basically there are two forms of life insurance—ordinary life purchased by the individual and group life purchased by the employer, usually with some contribution by the employee. As for ordinary life insurance, there are three types with which the accountant should be familiar — straight life, endowment and term insurance.

Straight life involves the payment of a stipulated amount at the death of the insured. Endowment policies call for payment of the face amount of the policy at the end of a stated period or at death, whichever occurs earlier. These policies also provide for alternative benefits at maturity, at the election of the policy holder. Thus, rather than an outright payment, the insured may elect to receive periodic payments, either for life or for a period certain; and if death occurs prior thereto, for the balance

of the period to a named beneficiary. Calculation of premiums on this type of policy involves the same principles as those used in the case of straight life insurance, with a mortality table based on the requirements of the selected type of settlement.

In connection with both types of policies discussed above, rather than the normal annual premium, the insured may use the limited payment plan. This involves higher premiums over a relatively short term, and the calculated cost of the policy is paid well in advance of maturity. In cases where an individual has present income greatly in excess of anticipated future income it is prudent to pay now for insurance protection needed later.

Both straight life and endowment policies are permanent in nature. There is also a temporary form known as term insurance. Under these policies benefits are payable only if death occurs during the period the policy is in effect, which may be one year, ten years, until 65, etc. Such policies, except in rare instances, have no other value and if they are renewed at the end of the period, invariably involve greatly increased premiums. At maturity, if the insured wishes to convert to a permanent form of insurance it is customary to permit this without further evidence of insurability at that time. Term insurance, although less costly than whole life, is meant to be used for a specific need, and when that need no longer exists it is wise to convert to a permanent form of insurance.

Group Life Insurance

The second basic classification of life insurance is designed to cover a group of individuals, usually in larger business organizations. Each member of the group is insured for a twelve-month period, renewable automatically while continuing to be a member of that group. The premiums are paid in part by the employer and by the employee, but annual fluctuations in premiums (due to changes in personnel) are borne by the employer. In large groups no medical examination is necessary and if an employee leaves the group, the policy may be converted to ordinary life insurance, with the payment of premiums at the effective rate called for on the conversion date.

Key Man Insurance

In many new organizations rapid growth in the initial stages may be due primarily to the personality or singular ability of one or two men. Until the organization is firmly established, the loss of these men might well provoke a financial crisis. Life insurance can provide funds at the death of these executives that will bridge the gap during the period when the business is beginning to function without them. A policy is taken out on the life of the key man, naming the company as sole beneficiary. Although the company cannot deduct the premiums for tax purposes,[2] the proceeds, being paid by reason of the death of the insured, will not be includible in income when received.[3] Normally this problem arises in the case of a newly organized business, but in every instance where it is obvious that successful operation is, to a great extent, dependent on individual ability, life insurance should be considered.

Business Purchase Agreements

Another type of business loss suffered by reason of the death of an individual has its remedy in the "Business Purchase" agreement. These agreements are entered into for the purpose of providing for the purchase of a decedent's interest in the business, thereby assuring the survivors of continuity of operations.

free from outside interference. The business purchase agreement is prevalent in partnerships and closely held corporations. Where life insurance is used to fund the contract, the agreement may be one of two types: the cross-purchase or the entity purchase. The former contemplates individual owners insuring the lives of each other, while the latter involves the business insuring the lives of the owners.

Whenever the accounts of a partnership are being reviewed, the accountant must consider the financial implications of the death of one of the partners. In the absence of an agreement to the contrary, death of any one member entails dissolution of the partnership. In the majority of instances, because of the nature of the business, a forced liquidation is not financially feasible. Where the partnership consists of no more than three individuals the cross-purchase agreement, funded by life insurance, should be recommended. In a two-man partnership each partner can take out insurance on the life of his co-partner, naming himself as beneficiary. Upon either partner's death the survivor has the tax-free proceeds of the policy to assist in the purchase of the decedent's interest. In the case of a three-man partnership each partner can take out insurance on the lives of his co-partners. Upon the death of any one partner his insurance on the lives of his surviving partners may be transferred to them or to the partnership and, in the event of their death. the proceeds will still not be taxable.[4] The limitation of a cross-purchase type of agreement to a three-man partnership is one imposed only by sound business practice. Any greater number of partners involved in the agreement would lead to administrative difficulties, as each partner would have to carry policies on the lives of all the other partners. Under an entity-purchase agreement the partnership would carry a separate policy on the life of each partner, thereby eliminating the necessity of transfers at death.

Before adoption by the partnership, the estate and income tax features of a purchase agreement must be considered to insure that any agreement will avoid tax consequences that would more than offset the anticipated business benefits to be derived therefrom. The Treasury Department has given its blessing to cross-purchase agreements in Rev. Rul. 56-397, C.B. 1956-2, 599, and also to entity-purchase agreements.[5] Under certain circumstances, however, an associate may wish to have the proceeds payable to his estate, with the understanding that they will be credited against the purchase price of his interest in the business. The rule has been established in *Estate of John T. Mitchell,* 37 BTA 1 (1938), that such insurance proceeds are includible in the gross estate; but if, by virtue of a business-purchase agreement, the estate is bound to credit the proceeds toward the purchase of the decedent's interest in the business, the value of such interest should be reduced accordingly.[6] It would appear, however, that the full value of the partnership interest *and* the proceeds of the insurance would be included for estate tax purposes, where the agreement does not specifically call for crediting of the proceeds against the purchase price.

In all of these agreements it is imperative that consideration be given to the tax basis of the purchased partnership interest in the hands of the survivors. In the case of cross-purchases and entity purchases no problem is presented. The proceeds having been received by the survivors and then paid over to the estate of the deceased partner. the basis is the entire amount so paid. Serious difficulty will be encountered in those cases where the decedent's

estate is the recipient of the proceeds. In *Paul Legallet* v. *Commissioner*, 41 BTA 294 (1940), insurance policies were obtained on the lives of both partners, proceeds payable to wife or children. Upon the death of one of the partners and the subsequent valuation of his interest in the business, the surviving partner paid over to the widow the excess of the purchase price over the insurance proceeds. At a later date, when part of these purchased assets were sold, the Treasury Department determined their basis to be confined to the actual cash paid by the surviving partner. Despite the fact that there was an agreement to the effect that the insurance proceeds received by the widow were to be credited against the purchase price of the deceased partner's interest, the Board of Tax Appeals held there was no constructive receipt by the surviving partner. No business-purchase agreement should, therefore, be entered into without a careful study of the facts and opinion in the Legallet case. In most instances discretion would dictate employment of cross-purchase or entity-purchase agreements.

Stock Redemption Plans

The second, and very complex, type of business-purchase agreement often funded through life insurance is the stock redemption plan. In closely held corporations it is usually desirable to provide for continuity of business policies that have hitherto been responsible for successful operations. To this end agreements are originated compelling stockholders to give the company an option to acquire their stock, either by purchase during the stockholder's life, or upon his death. The company then takes out insurance on the lives of the parties to the contracts in an amount estimated to be sufficient to redeem the stock. Until 1950 such an arrangement seemed to present no tax problems. The first sign of trouble was encountered in the case of *Emeloid Company, Inc.* v. *Commissioner*, 51-1 USTC ¶66,013, 189 F (2d) 230, (CA-3), rev'g. CCH Dec. 17,713, 14TC 1295 (1950). This case involved inclusion of a corporate loan in invested capital for excess profits tax purposes. The loan was used to finance the purchase of a single premium "key man" insurance policy, and the question to be resolved was whether the utilization of funds in this manner constituted a legitimate corporate business purpose. Approximately four years after the loan was made, in an agreement between the corporation and the stockholders, the insurance was placed in trust to fund a stock redemption plan. The Tax Court held that the benefits to be derived from the insurance inured to the stockholders and not to the corporation. In the event of death, the deceased was assured of the purchase of his stock by the corporation, and the surviving stockholders benefited to the extent of retention of control. The Third Circuit reversed the Tax Court, pointing out that the company would have funds available to tide it over the period immediately following the death of a key man, and would also have the assurance of continuity of management, free from outside influence.

Since the decision in the Emeloid case, in every instance where any unusual element enters into a stock redemption agreement, the Treasury Department has been scrutinizing the contracts and attempting to impute tax liability to the stockholders. Presently the Prunier and Sanders cases are the subject of great concern. Tax publications are replete with discussions of the necessity of a review of the situation in the light of principles enunciated therein.[7] It is obvious that until final

decisions have been handed down on appeal, many presently existing stock redemption agreements funded by life insurance are in extremely vulnerable positions.

The Prunier and Sanders Decisions

In *Henry E. Prunier*, CCH Dec. 22,327, 28 TC — No. 4 (1957), two brothers, owning substantially all of the stock of a company, entered into a cross-purchase agreement funded by life insurance. Upon the death of either, the survivor was to turn over the insurance proceeds to the company to purchase the stock of the decedent. The corporation paid the premiums on these policies, and in 1952, when the Treasury Department first raised the question of taxability of premiums, the corporation was named sole beneficiary. Each insured continued, however, to reserve the right to change the beneficiary. The Tax Court deemed the premiums paid by the corporation to be taxable to the stockholders on the theory that the company would receive no benefits from the insurance proceeds, the company's creditors would not be able to levy on the proceeds, and the survivor's proportionate interest in corporate capital would be increased. In the dissenting opinion (this was a four-to-three decision), it was pointed out that the corporate entity cannot be ignored, and all corporate benefits indirectly benefit stockholders.

The *Prunier* case has just been reversed by the Court of Appeals in *Prunier* v. *Commissioner* (CA-1, 11/8/57, rev'g 28 TC No. 4, DER No. 74 of 1957). In its opinion the Court stated: "Human beings take advantage of laws permitting incorporation because they think it will be economically advantageous to them individually. That is so whether the corporation is a "closely held" company owned by two stockholders, or one having two thousand stockholders. In a loose manner of speaking, it can be said that any corporate gain is a benefit, indirectly, to the stockholders, so that if a corporation becomes the beneficial owner of insurance policies, the stockholders receive the benefit thereof. Of course, this argument proves too much, for it would lead to the conclusion that profits made by a corporation in its business are automatically taxable income to the stockholders. This is contrary to the taxation scheme of the Internal Revenue Code."

A similar opinion was handed down in *Sanders* v. *Fox*, 57-1 USTC ¶ 9661, 57-2 USTC ¶ 9794 (D.C. Utah). In this case four stockholders entered into an agreement with the company whereby stock was to be redeemed through the medium of life insurance. The right to name the beneficiary was reserved unto the insured, but the decedent's stock had to be surrendered to the company for the proceeds, or, if the agreed value was greater, for the proceeds plus a cash payment by the company. The Court held that continuity of management benefits flowing to the corporation was only incidental to the real results intended—that of assuring the stockholder redemption of his stock at a fair market value upon death, an assurance not ordinarily present in the case of a closely held corporation. As a result thereof it was deemed that the insurance premiums paid by the company were taxable income to the individual stockholders.

The recent reversal of the Tax Court in the *Casale* case involving deferred compensation,[8] as later discussed, was the standard of measure applied by the Court of Appeals in the *Prunier* case; and it is anticipated that a similar decision will be handed down on appeal of the *Sanders* case. It would seem that the unusual fact situations present in both of these instances have been responsible for the attempt on the part of

the Treasury Department to disregard the corporate entity. In any event, when the accountant is made aware of the existence of stock redemption agreements he should notify the client of current diversity of opinion in this field, and suggest that counsel for the company review the agreements in the light of these cases. If no agreement is in existence and one seems indicated under the circumstances, care should be taken to see that the agreement and the life insurance contract are completely independent. In the case of life insurance, the corporation should be named as beneficiary and retain all incidents of ownership in the policy.

Taxable Dividends

Another decision handed down this year dealt with the proceeds of insurance being taxable as a dividend. In *Thomas F. Doran*, CA-9, 7/9/57, rev'g. TC Memo 1956-121, an insurance trust was established to fund a stock redemption agreement. The trustees (officers of the corporation) were beneficiaries, and the premiums were paid by the corporation and charged to surplus. Upon the death of the president the trust purchased his stock. The Tax Court held that this constituted a dividend to the remaining stockholders, as the corporation was the beneficiary of the policy, and its purchase of the stock was for the benefit of the surviving shareholders. The Court of Appeals reversed on the grounds that the trustees purchased the insurance for the benefit of the stockholders, not the corporation. While this eliminated the question of the dividend levy, it would certainly mean that the premiums being paid by the corporation are additional compensation. This, then, is one other form of stock redemption agreement that should be avoided.

Deferred Compensation Plans

Any device that may be availed of by a business that will result in greater benefits to the employee will be advantageously reflected through the financial rewards arising from increased loyalty, maximum efficiency and minimum turnover in personnel. The accountant should familiarize himself with all possibilities in this field and point them out to management. One such possibility, and one in which life insurance may play an important role, is the deferred compensation plan. In view of high tax rates prevailing even in relatively low income brackets, the postponement of a portion of compensation is attractive to the employee. Any immediate increment of a sizable amount means greatly increased taxes; then at retirement, when funds are needed to maintain living standards and, in most cases, greatly increased medical expenses, income falls off appreciably. Today more and more companies are installing deferred compensation plans as a means of stabilizing employees' income.

When considering the adoption of a deferred compensation plan, the possibilities of funding through life insurance should be called to the client's attention. A contract may be entered into with the employee providing for payment of a lump sum at retirement, or, in the alternative, periodic payments for a specified term. Periodic payment plans are usually coupled with consultation agreements justifying such payments beyond the normal age of retirement. The company then enters into a separate endowment contract, based on the life of the employee, and having a maturity date coincident with the time the obligation under the deferred compensation plan has to be met. It must be understood that the endowment contract and the employment contract are completely independent of one another—the former is merely a means whereby the company makes funds available to meet another obligation at a future date.

When the policy matures, the company may receive the entire proceeds with which to satisfy an employment contract calling for a lump-sum payment. Tax will have to be paid on any amount received in excess of premiums paid,[9] but it will be computed as if the proceeds had been received ratably over the year of payment and the two previous years.[10] If corporate income is in the 52% bracket during the three-year period, this provision of the Code produces no tax benefit, but if in any one of these years the company is in the 30% bracket, a tax savings will result.

If the employment contract calls for annual payments, as is usually the case, the company may wish to fund them out of the presently maturing endowment policy. Under these circumstances, an election to receive an annuity may be made within sixty days after the date on which the proceeds first became payable. The lump-sum tax provisions will not apply where an election is exercised,[11] but rather the general exclusion provisions under 1954 Internal Revenue Code Sections 72(a), (b) and (c). In every instance the deferred compensation is a proper deduction for the period in which it is paid to the employee.

In addition to the above tax consequences, the company may realize a financial benefit not originally contemplated, in the event of the death of the insured. For example, if the company takes out a twenty-year endowment policy, pays one year's premium, and then the employee dies, the company receives the face amount of the policy tax free. As in the case of all key man insurance, premiums are not deductible and the corporation must be named sole beneficiary.

The Casale Decision

Funding of deferred compensation contracts through the medium of life insurance should not be considered without reference to the Casale case.[12] Such contracts and method of funding are most frequently found in the case of closely held corporations where the method is administratively feasible, and the Casale case involves that problem. On September 5, 1957, this controversial Tax Court decision was reversed by the Court of Appeals, but the Treasury Department's trend of thought indicated therein should not be ignored. In this case the corporation, of which the president was a 98% stockholder, adopted a deferred compensation plan effective on the president's sixty-fifth birthday. On the same day insurance was taken out in an amount sufficient to meet the future compensation obligation, and naming the company as beneficiary. The Tax Court upheld the Commissioner's contention that premiums on this policy paid by the company were taxable as a dividend. It was contended that the corporation was no more than a conduit running from the insurer to the insured. This of course is the same theory applied in the Prunier and Sanders cases now up on appeal. The Circuit Court reversed with this comment: "We have been cited to no case or legislative provision which supports the proposition that the entity of a corporation which is actively engaged in a commercial enterprise may be disregarded for tax purposes merely because it is wholly owned or controlled by a single person." From the above it will be seen that in the case of a close corporation careful consideration must be given to tax consequences which may be imputed to deferred compensation plans funded by life insurance.

Split-Dollar Insurance

In any large corporation having a fairly representative group of young executives, the accountant should ascertain whether the company has con-

sidered the possibilities of split-dollar insurance. While benefits rest primarily with the executive, adoption of such a plan is one of the fringe benefits responsible for promoting loyalty and good will, and the company at all times has its investment protected. Inasmuch as there are no restrictions as to a class or classes of employees to be covered, the company is free to single out individual employees it desires to aid.

Briefly stated, split-dollar insurance is an interest-free loan[13] by an employer, which enables an employee to carry life insurance at that period when a growing family and establishment of a home leave little or no money available for insurance protection. The company takes out a policy on the life of an executive, the latter paying the first premium. Thereafter the company pays a portion of each annual premium to the extent of the annual increase in the cash surrender value of the policy. Ultimately this annual increase exceeds premium costs, and all future premiums are paid by the company. In the case of a thirty-five year old executive the point where the company assumes payment of all premiums usually occurs sometime between the seventh and tenth year. To the extent of the cash surrender value of the policy, the company is the beneficiary; and any proceeds in excess of this amount are payable to the beneficiary named by the executive. The company may not deduct the premiums on this type of policy for tax purposes, as such payments are actually deemed to be a loan. By the same token the payments will not be regarded as additional compensation to the executive.

From the corporate point of view, the net cost of split-dollar insurance is nominal and far outweighed by employee good will gained. Actually, what it amounts to is loss of interest which could have been earned on amounts expended for premiums, after Federal income tax thereon, offset by tax-free gain on proceeds in excess of premiums paid, realized upon the death of the employee. From the employee's point of view he is receiving financial aid in carrying adequate insurance at the inception of his career, and, as his share of coverage decreases, so does his expense. From the practical point of view when the employee is on sounder financial footing the policy should be purchased from the company at its then cash surrender value, and full insurance protection will then be restored. The company in this instance will only pay a capital gains tax on the amount received in excess of premiums paid, which still keeps the cost at a minimum.

If the employer is not interested in this type of plan it might be well to point out to younger executives the possibilities of a similar arrangement under "bank financed" life insurance. Here the bank assumes the employer's role in the split-dollar insurance plan, contributing to annual premiums to the extent of the increase in cash surrender value. There is one danger here, however, in that an attempt has been made to deny a deduction for interest paid on such loans. The House Ways and Means Committee recently rejected a proposed amendment to the code in the Technical Amendments Bill of 1957, which would have prohibited a taxpayer from taking an interest deduction in a periodic-payment bank-financed loan.[14] For this reason future proposed amendments must be carefully watched and the executive guided accordingly.

Five Thousand Dollar Death Benefit Payments

Payments to widows of employees have been at issue in many tax cases in recent years. To date no standard has been established that will enable an employer to make such payments with

any degree of certainty as to their tax treatment, with one exception. Section 22(b)(1) of the Revenue Act of 1951 permitted a corporation to pay up to $5,000 as a death benefit to a named beneficiary or estate of a deceased employee. Such payments were deductible by the corporation and tax-free to the recipient, provided they were part of a formal employment contract. Section 101(b) of the Internal Revenue Code of 1954 lifted the contractual restriction, and more and more companies have now adopted the practice of making death benefit provisions part of their employment program. Life insurance funding of these payments is of valuable help and should be called to the attention of management. A policy in the face amount of $5000 may be taken out on the life of the employee, naming the company as beneficiary. The premiums will not be deductible, but the proceeds received on the death of the insured will, of course, be tax-free and available for the payment to the named beneficiary or estate of the deceased employee. The cost to the company of the death benefit payment will be either $2400 or $3500, depending on whether the company is in the 52% or 30% tax bracket. An offset to this is the tax-free insurance proceeds received, reduced by the amount of premiums paid; and the net cost to the company, when measured against the benefits derived from increased employee morale, make such a plan worthwhile.

Term Insurance

An explanation of term-insurance coverage and its function under group life plans was given at the beginning of this article. Protection exists only for the term of the policy, and only in rare instances is there a cash surrender or loan value feature involved. Presently the tendency is to give employee benefits that will be tax-free—again with the idea of promoting a feeling of loyalty and good will. Group life insurance provides relatively high coverage at low cost, the premiums paid are deductible by the employer and tax-free to the employee.[15] Unless employee turnover is so rapid as to incur prohibitive insurance premiums, group life insurance is a desirable part of any fringe benefits program.

Alimony

Thus far life insurance has been considered in cases where a business operation may derive a direct or indirect benefit therefrom. Frequently, however, the accountant is consulted by management in matters of a personal nature, and only too often answers to these personal problems serve as a criterion of accounting ability. Of necessity every accountant should be familiar with certain personal life insurance problems and their tax consequences.

Certain sections of the Internal Revenue Code govern the tax treatment of alimony, other sections deal with the taxation of life insurance, and many technical problems arise with the fusion of the two elements. Basically, periodic alimony payments will be deductible by the payor and taxable to the recipient where made pursuant to a decree of divorce or separate maintenance, or in accordance with a written separation agreement after August 16, 1954 where no joint return is filed.[16] On the other hand, payments of a lump sum to discharge an alimony obligation are neither deductible by the payor nor taxable to the recipient. Installment payments, which by decree are made or may be made over a period in excess of ten years, are deemed periodic payments,[17] but only to the extent that the amount received during the payee's taxable year does not exceed 10% of the principal

sum. With these fundamental principles in mind it is obvious that where life insurance is used to fund alimony payments the tax treatment of insurance proceeds will have to be reconsidered in the light of the obligation they are satisfying.[18]

Where a decree requires the husband to take out a policy or assign a presently existing policy in favor of his spouse, the premiums paid will be considered periodic, deductible by him and taxable to his wife. Upon the husband's death the wife, having released her spouse from the obligation to support, will be treated as a transferee for value, and any excess of insurance proceeds over the value of the assigned policy plus premiums subsequently paid will be subject to ordinary income tax in her hands. The situation is different, however, where the insurance is merely a bond for the performance of an obligation. These cases arise where the policy is assigned for a particular period until an alimony obligation is satisfied, or the decree orders an insurance policy as security for the continuance of alimony after the husband's death. Here the premiums will not be taxable to the wife, and upon death the proceeds will be includible in the husband's estate by virtue of Section 2042 (1) of the Internal Revenue Code of 1954.[19] By the same token the obligation to pay continuing alimony becomes a claim against the Estate, and deductible under Section 2053 of the Code. No marital deduction for estate tax purposes is available against alimony insurance under a divorce decree, as the beneficiary cannot be considered a surviving spouse; but alimony insurance under a separation agreement, with no divorce, is subject to the marital deduction.

Ordinarily periodic payments under insurance, endowment or annuity contracts are taxable to the wife where a trust has been established or property transferred by the husband for the purchase of the contract.[20] Some tax benefit may result, however, if the decree merely specifies annual payments and they are funded by life insurance. The husband purchases an annuity for his own benefit, or elects to take annuity payments in lieu of a lump sum settlement under an endowment contract, in an amount sufficient to fund the periodic payments. While the annuity payments are taxable to the husband they are subject to the exclusion formula governing taxation of annuities,[21] and yet payments of an equal amount made to the wife are deductible in full. As long, therefore, as the exclusion ratio persists there is a small tax savings involved.

Because of periodic payment requirements, if a life insurance policy is assigned to the wife in accordance with a divorce decree, it will not be taxable to her or deductible by the husband. It would seem, however, that if an obligation under a decree exists, and the wife agrees to accept assignment of life insurance in satisfaction of that obligation, a different tax result arises. Life insurance is a capital asset, and where used to satisfy an obligation, constitutes a sale or exchange of the policy.[22] The husband would be taxed at capital gains rates on the excess of the fair market value of the policy over the cost as of the date the debt is discharged. The value of the discharged debt, in an arm's-length transaction, would be determined by reference to the value of the policy for which it was exchanged.[23] No loss would be recognized as any cost in excess of value received would be considered payment for death protection prior to assignment.

Exchange of Policies

Very often a client will be carrying one type of insurance policy for several years. With the passage of time, altered circumstances may dictate a revision in

insurance planning and it would be helpful to know the taxation features involved in any exchange of policies. No gain or loss will be recognized where a contract of life insurance is exchanged for another life insurance contract or for an endowment or annuity contract.[24] Similarly, no tax attaches to the exchange of an endowment or annuity contract for another annuity contract; or an endowment contract for another endowment contract, calling for regular payments beginning at a date not later than payments would have begun under the old contract. All other transfers are taxable. Without such limitations, just prior to maturity, the holder of an endowment policy could convert to straight life, using any cash received on conversion to reduce the cost of the new policy. Upon death the entire proceeds would be received tax free, and the reduced cost basis would be immaterial. It is important, then, to consider the possible tax cost of policy transfers when calling on an insurance man for revisions.

Debtor-Creditor Relationship

Ordinarily the payment of life insurance premiums is a personal expenditure and not deductible for tax purposes. This is so even if the insured takes out the policy solely as a means of securing his loan, as the discharge of his obligation through application of the life insurance proceeds means that indirectly he is the beneficiary of the policy. There is one instance, however, where payment of insurance premiums is deductible as an ordinary and necessary business expense. If a debtor assigns a policy on his life to his creditor as security for a loan, and the creditor continues to pay premiums with the hope of ultimate recovery of the indebtedness, the creditor will be allowed a deduction for such payments. GCM 14,375 (CB June 1935, p. 52) attaches two conditions for deductibility—the creditor has no right to reimbursement of the premiums, or, if such right exists, it is worthless. These conditions will be satisfied if the right exists but collection from the debtor is impossible, and the cash surrender value of the policy in year of premium payment will not cover the original debt and premium costs.

Estate Planning

While it is necessary to employ the services of attorneys, trust advisors and insurance men, the accountant, through his individual contacts in his professional capacity, is in the position of being able to focus attention to the importance of life insurance in estate planning. Where the husband is currently expending most of his income on the establishment of a home and raising a family he must examine the financial position of that family in the event of his death. Mortgage insurance will take care of the debt on his home, but the support and education of the children will require a substantial cash expenditure each year. Social security payments will be one source of income, the wife receiving monthly benefits until the youngest child reaches eighteen, and then nothing until she herself attains the age of sixty-five. As these are only nominal payments the wife must either seek employment or there must be some provision made for additional annual income.

Life insurance is the most logical way of providing additional income. The husband will take out a policy naming his wife as beneficiary, or his wife can take out a policy on his life, thereby eliminating any incidents of ownership on the husband's part. Upon the husband's death the wife will elect to take the insurance in installments, either for a term of years or for life, depending on the then existing financial needs. To the extent that the annual payments in-

clude an interest element, normally that is taxable income. Section 101(d) of the Code, however, permits an annual exclusion of not more than $1,000 if the beneficiary is the surviving spouse. Thus, if the wife elects to take ten annual installments of $6,000 each in lieu of the face amount of a $50,000 policy, the entire amount will be received tax-free annually. One-tenth of the face amount of the policy ($5,000) will be the prorated amount held by the insurer and excluded under Section 101 (d)(1)(A) of the Code. The balance of $1,000 is the interest element, also excludable. Regardless of the number of policies or amounts received by the spouse, only $1,000 interest may be excluded in any one year. A further tax saving is realized if this insurance policy qualifies as a marital deduction under Section 2056(b)(6) of the Code, as the proceeds will then be deductible from the insured's gross estate. To qualify, the beneficiary-spouse must have the right to designate the beneficiary of all amounts remaining unpaid at her death, and the annual installments must commence no later than thirteen months after death. As time goes on and the financial picture alters considerably, the younger man can always exchange this life policy for an endowment or annuity contract, more suitable in the light of current needs, and there will be no tax consequences.

Estate and Insurance Planning for the Executive

An executive with considerable personal assets has a somewhat different problem. His investment portfolio may contain large blocks of stock, debts of a sizable nature may be outstanding, and administration expenses may be anticipated to be high. To this man the main concern is the necessity for ready cash to prevent the forced selling of his investments in a depressed market or, if the holder of a large block of stock, to prevent selling at a reduced price because of his holdings suddenly flooding the market. Section 303 of the Code grants some measure of relief. If a corporation redeems part of its stock, held by a deceased shareholder and includible in his estate, for an amount not exceeding the sum of death taxes, funeral and administration expenses, the redemption will be treated as an exchange, taxable as a capital gain. This relief is available only in certain fact situations, and for the most part one must look to life insurance to provide ready cash. The executive estimates as closely as possible the estate's cash requirements and takes out a policy to meet those requirements. Of course any estimate must take into consideration the increased estate tax due to the inclusion of the policy in the estate.

An entirely different approach to the problem is involved where the wife has little or no property of her own and the husband's estate is fairly liquid, consisting of cash, insurance and a diversified portfolio of securities. In view of the fact that gift tax rates are lower than estate tax rates the husband should exercise his lifetime exemption by transferring property having a value of $30,000 to his wife, and also establish the custom of annual gifts of $6,000, utilizing his annual exclusion to one donee of $3,000, plus the marital exclusion to the extent of the other $3,000. A good portion of his property will thus be diverted to his wife, and a savings effected to the extent of the lower gift tax rate. Life insurance may be part of the property so transferred, but care must be taken to see that no incidents of ownership rest with the husband after assignment. Of course any such transfers made within three years of the date of death will have to be proved as not having been made in contemplation of death and includible in the estate.

The husband can also avail himself of the marital deduction by bequeathing one-half of his estate to his wife, provided the conditions of Section 2056 of the Code are met, and this bequest will escape tax in his estate. Here again life insurance can be part of the bequest subject to the limitations of Section 2056(b)(6) of the Code.

In all cases where life insurance is transferred, the adviser should guard against any possibility of a reversionary interest, thereby subjecting the policy to estate taxation. A reversionary interest to the extent that it has a value immediately before the death of the insured of more than 5% of the value of the policy will constitute an incident of ownership within the meaning of Section 2042 of the Code.

References

1. H. P. C. Howe, "A Public Relations Program for CPAs," *The New York Certified Public Accountant*, January, 1957.
2. I.R.C. of 1954, Sec. 264.
3. I.R.C. of 1954, Sec. 101(a) (1).
4. I.R.C. of 1954, Sec. 101(a)(2)(B). The recipient is not deemed to be a transferee for value.
5. See Letter dated 11-24-47, signed D. S. Bliss, Deputy Commissioner, 4A P-H 1955 Fed. Tax Serv. ¶ 120, 427.3.
6. John T. Mitchell rule applied in letter of D. S. Bliss, supra, note 5.
7. Some of the interesting articles discussing these cases are:
   Mannheimer and Friedman, "Stock Retirement Agreements—The Prunier and Sanders Cases," *Taxes*, August, 1957, Vol. 35, No. 8, p. 567.
   Steinberg, "Funding Stock Redemption Agreements with Life Insurance," *Taxes*, September, 1957, Vol. 35, No. 9, p. 669.
   Lawthers, "Prunier Offers No Threat To a Sound Insured Buyout Plan," *The Journal of Taxation*, Vol. 7, No. 1, p. 2.
   Taylor and Maier, "Sanders Case Again Emphasizes Care Needed in Agreements Funded by Insurance," *The Journal of Taxation*, Vol. 7, No. 2, p. 68.
8. *Oreste Casale*, 26 TC 1020 (1956) rev'd on appeal CA-2 (1957) Dock. 24476, 9/5/57.
9. I.R.C. of 1954, Sec. 72 (c) (1) (B).
10. I.R.C. of 1954, Sec. 72 (e) (3).
11. I.R.C. of 1954, Sec. 72 (h) (1), (2) and (3).
12. See note (8) supra.
13. See Rev. Ruling 65-713, C. B. 55-2, p. 23 for the exact requirements.
14. Reg. 1.264-2 deny a deduction for interest on a loan used to finance the purchase of a single-premium life insurance or endowment contract. This includes any contract where substantially all the premiums are paid within four years from date of purchase, or an amount is deposited with insurer after March 1, 1954, for payment of a substantial number of future premiums.
15. O.1014, CB June, 1920, p. 88.
16. I.R.C. of 1954, Sec. 71 (a).
17. I.R.C. of 1954, Sec. 71 (c).
18. For example Section 72(k) specifically exempts payments to a wife under Section 71 or 682 from the rules ordinarily governing annuities, endowment and life insurance contracts set forth in Section 72. Likewise Section 101(e) specifically deprives life insurance proceeds of their non-taxability feature when used to finance payments under Sections 71 and 682.
19. Reg. 105 § 81.26 states that insurance proceeds are receivable for the benefit of the estate "so long as there is an obligation, legally binding upon the beneficiary, to use the proceeds in payment of . . . taxes, debts or charges." See also *Estate of Silas Mason*, 43 B.T.A. 813 (1941).
20. I.R.C. of 1954, Sec. 71(d) and 215(a).
21. I.R.C. of 1954, Sec. 72(b).
22. *Commissioner* v. *Halliwell*, 131 F. 2d 642 (2d Cir. 1942).
23. Ibid.
24. I.R.C. of 1954, Sec. 1035.

Federal Income Tax Legislation of 1957

By Arthur J. Dixon, C.P.A.

Tax legislation actually enacted in 1957 was very limited. There are, in various stages of the legislative process, however, many changes which may very well become law in 1958. These potential changes are too numerous to be detailed in this article, but, because of their possible retroactive effects, a general description of the bills will be given.

Public Law 85-12, approved on March 29, 1957 was termed the "Tax Rate Extension Act of 1957." This Act extended for 15 months, from April 1, 1957 to July 1, 1958, the existing corporate normal tax rate of 30 per cent and various existing excise tax rates.

On August 26, 1957, Public Law 85-165 was signed. It provided for two tax changes.

1. Section 1305 was added to the 1954 Internal Revenue Code. It applies to a taxpayer who receives or accrues an amount of $3,000 or more as an award of damages in a civil action for breach of contract or fiduciary duty. If a lesser tax results, the taxpayer may spread such award over the period during which it would have been received but for the breach of contract or fiduciary duty. It is effective for taxable years ending after December 31, 1954 but only as to amounts received or accrued after December 31, 1954 as the result of awards made after that date.

2. Section 168 of the Internal Revenue Code was amended to severely restrict the issuance of certificates of necessity for rapid amortization of emergency facilities. After August 22, 1957, certificates will be issued only for (a) facilities producing new or specialized defense items for use by the Department of Defense or the Atomic Energy Commission in the national defense program, or (b) facilities providing research, developmental or experimental services for the Department of Defense or the Atomic Energy Commission as a part of the national defense program. No new certificates at all will be issued after December 31, 1959.

The time within which a minister may elect self-employment tax coverage was extended by PL 85-239, which amended Section 1402(e) of the Code. Such election must now be made by the due date of the minister's income tax return (including extensions) for his second taxable year ending after 1956.

The following tax treaties or amendments thereto became effective in 1957:

1. The convention between the U. S. and Honduras applies beginning January 1, 1957 as the result of the ex-

Arthur J. Dixon, C.P.A. *and member of the New York Bar, is a member of our Society and of its Committee on Federal Taxation. Mr. Dixon is a partner of the CPA firm of Oppenheim, Appel, Payson & Co. He is also a member of the Committee on Income of Estates and Trusts of the Tax Section of the American Bar Association.*

change of instruments of ratification on February 6, 1957. This convention is the first of its type to be concluded with any of the American Republics, and follows the general pattern of other tax treaties. Interest from U. S. sources paid to a nonresident alien who is a resident of Honduras or to a Honduran corporation or other entity is exempt from U. S. tax. Most dividends from U. S. sources are not covered by the treaty, however, and are subject to the usual taxes imposed on nonresident aliens.

2. A supplementary tax convention with France became operative on June 13, 1957. The most important change provides a rate of 15 per cent, retroactive to January 1, 1952, on dividends and interest from sources within one of the countries paid to a nonresident alien who is a resident of the other country or to a corporation or other entity of the other country.

3. A supplementary tax convention with Canada became effective retroactive to January 1, 1957. Among other things, the new treaty reduces from 95 per cent to 51 per cent the percentage of share ownership which entitles a United States parent company to the reduced tax rate of 5 per cent on dividends from its Canadian subsidiary. In addition, charitable contribution deductions are reciprocally allowed for gifts to charitable organizations in the other country, limited, however, to a percentage of the income from sources in the other country.

4. The new tax treaty between Austria and the U. S. goes into operation as of January 1, 1957. It follows, with some exceptions, the general pattern of such treaties. The rate of tax imposed on dividends by the country of source is limited to 50 per cent of the statutory rate. Interest to an amount not exceeding a fair and reasonable consideration on the indebtedness is exempt from the tax of the source country. The exemption is not applicable to interest on debts secured by mortgages.

5. A treaty with Pakistan, which has been signed but not yet approved by the Senate, contains a new type of provision designed to encourage United States investment in Pakistan. Subject to certain limits and conditions, a U. S. corporation would be permitted to claim a foreign tax credit as though it had paid the Pakistan tax from which it was actually exempt under the Pakistan law as a new enterprise.

The following two bills of general interest are in the legislative mill and should be considered for their possible retroactive effects:

1. H.R. 8381, Technical Amendments Act of 1957. This bill was reported by the House Ways and Means Committee but was not acted on by the House itself. It contains 81 sections, many of which are proposed to be applied retroactively. The bill includes the provisions dealing with the unintended tax benefits and hardships presented by the Treasury Department, as well as many other technical changes.

2. H.R. 7125, Excise Tax Technical Changes Bill of 1957. This bill was passed by the House of Representatives and will, it is expected, be the subject of Senate Finance Committee hearings early in the next session. It represents the most comprehensive technical revision of the excise tax provisions since 1932.

In addition to the above, there are a number of bills dealing with specific problems which have either been passed by the House of Representatives or reported by its Ways and Means Committee. These include a provision requiring the deposit of income and social security taxes withheld and excise taxes collected, in a special trust account un-

der certain circumstances; an amendment to section 421(d)(6) which would recognize a new basis, reflecting the market value of the underlying stock, on the death of an employee holding a restricted stock option; a relief provision granting an exempt employees' trust the right to make inadequately secured loans to the employer under prescribed conditions; a section applying involuntary conversion treatment for property disposed of as a result of antitrust proceedings under the Sherman Act or the Clayton Act; and an addition to the Code which would grant substantially the same treatment for real estate investment trusts which are widely held and which restrict their investments to those of a passive or nonoperative nature, as present law provides for regulated investment companies.

Tax Return Preparation and Tax Planning

One of the main methods of increasing profits is taking advantage of all proper deductions in the preparation of your tax returns. A proper income tax return depends on a sound determination of income. The professional public accountant is specially trained and experienced in this kind of work. He will prepare your returns and advise you about filing them. Even more important than preparing the return, however, is the planning which goes before the final preparation.

Careful tax planning begins on the first day of the year and continues until the returns are filed. Tax planning includes—but is not limited to—the following:

1. Studying carefully the most economical form of organization from a tax standpoint.

2. Analyzing accounts receivable to be sure that worthless accounts are written off or that sufficient reserves are provided against possible losses.

3. Verifying inventories to make sure that taxes are not paid on obsolete or worthless items or on excessively valued materials.

4. Examining plant and equipment accounts to be certain that the charges for depreciation, obsolescence, or abandonment are sufficient, and to determine whether items of equipment should be sold or traded in.

5. Studying carefully potential liabilities with a view to settling them in the highest tax years.

6. Reviewing income accounts with a view to controlling income by speeding up or slowing down shipments or by other proper and permissible means.

7. Examining expense accounts to determine whether such expenses as advertising, repairs, and supplies should be incurred in the current year or deferred.

8. Assuring that sufficient funds are being set aside to pay taxes when they fall due.

There are other ways of saving taxes which have been effective at specific times and in specific industries; your public accountant will know about them. He will have a knowledge of tax-saving plans which have been used successfully in businesses just like yours. He will assist you in determining whether a deduction taken for present expediency may cost you money later.

U. S. Small Business Management Series No. 5, "Public Accounting Services For Small Manufacturers," November 1954

A Banker Views the CPA's Opinion

By Frank D. Terry

Bankers sometimes may follow two extremes: unquestioning acceptance of any report on an accountant's stationery; or refusal to deal with a borrower unless the report bears an unqualified opinion of a prominent firm. At the root of the problem may be the failure to understand the meaning of the CPA's opinion — unqualified or qualified — or disclaimer of opinion.

What is the banker's reaction when he attempts to work with the results of the CPA's efforts and what are his thoughts when he encounters the opinions of the independent public accountant — unqualified, qualified or disclaimed? Before pursuing this question further, it would seem appropriate to cover very briefly the considerations which cause an accountant to disclaim an opinion or to qualify his opinion. By doing this we can cover the ground more simply than if we try to find a definition or a complete explanation of what he must do and what he must find in order to express an unqualified opinion.

Starting with the scope of an examination, I think we can all agree that the matter of scope is not necessarily the yardstick for measuring whether or not an unqualified opinion can be given. Generally speaking, where scope is inadequate to a degree that it precludes an unqualified opinion, the accountant usually cannot find adequate support for a qualified opinion and therefore in most cases would disclaim an opinion. Scope alone, however, is not the only answer. The accountant may be satisfied that the scope of his examination was sufficient to warrant an opinion as to the fairness of the presentation, but still be unwilling to give an opinion because of reservations as to certain material items or the lack of proper accounting methods or procedures. Probably in such cases he will also disclaim an opinion. However, where the accountant is satisfied as to the scope and his reservations relate to relatively immaterial items on the balance sheet, he may issue an opinion subject to qualifications relating to those items.

Frank D. Terry *is Vice-President of The First National City Bank of New York, having joined the First National Bank of the City of New York in 1933. He is the current Chairman of the Committee on Cooperation With Public Accountants of the New York Chapter of the Robert Morris Associates.*

Two Extremes

Now we come to the question of how the banker looks at these opinions unqualified, qualified or disclaimed when they arrive on his desk from a client. There are some extremes which I think we can eliminate from our discussion at the start. The first extreme is the national company with securities listed

on the various exchanges coming under the jurisdiction of the Securities and Exchange Commission, whose figures are frequently accompanied by the unqualified certificate of a major accounting firm. At the other extreme are those very small business enterprises frequently not incorporated, often with no audit of any kind, and where any bank credit granted them is based almost entirely on the banker's knowledge of, respect for, and confidence in the individual concerned. We have left, therefore, the large middle segment of business enterprises, some incorporated, some partnerships and some proprietorships. In many cases their bookkeeping is good, their accounting methods are proper and their procedures meet with the requirements generally considered standard.

Bankers, from my experience, are just about as extreme as the two classes of customers which I have outlined. There seems to be one group of bankers who embrace a childlike faith in anything with an accountant's name on it. At the other end of the line there is the impractical purist who will have no truck with any borrower unless his statement has the unqualified opinion of a nationally recognized accounting firm. I believe that both of these extreme points of view are equally bad.

Failure to Consider the Meaning of the CPA's Opinion

In the case of both extremes, I feel that the banker makes no effort to read what the accountant has to say about the work he has done, nor would he have any real understanding of what was said if he read it. Frankly, the latter statement is probably at the root of most of the misunderstandings which arise between bankers and accountants, bankers and customers, and accountants and clients. If one of the clients does not understand what the CPA means when he expresses a qualified opinion or why he does qualify that opinion, or does not understand why a disclaimer is issued, then he has no appreciation of the merits of his statement when he tries to use it for credit purposes.

By the same token the banker really is traveling an unchartered course if he accepts a qualified opinion or a statement with a disclaimer unless he understands exactly why they were issued and is satisfied that there are circumstances beyond normal ones which justify his granting the credit sought, based upon the figures to which the qualified opinion or disclaimer is attached. I do not know how many times in the years I have been in credit work in the banking field, I have been asked the question, "Are his figures audited?" but I think I can count on the fingers of one hand the times that question was followed up by, "Is the auditor's opinion satisfactory to us?" To me that means that those of us in the banking business who have something to do with bringing along the younger men who some day will succeed us, have a real responsibility to see that they read and understand what an accountant says about the work he has done.

Prior Discussion of Type of Audit Desired

We have a further responsibility in regard to our customers. We should make very clear to them our desires as to the kind of an audit we consider necessary for judging the merits of their requests for credit and we should make these wishes known to them *before* they engage their accountants to make an audit, rather than criticize the report after it has been received. It is in this area of discussing the kind of audit necessary with a client, that the approach of the banker who operates in blind faith and that of the idealist both fail. The loan officer must appreciate

that in certain cases he is perfectly sound in accepting a qualified opinion. In fact, he would be unreasonable to insist on putting his client to the unnecessary expense involved in obtaining an unqualified opinion. Such expense as I refer to is not the expense of the accountant's fee but more important is the hours of work to cover some points which are immaterial from a credit standpoint in the particular case in question.

There are situations particularly among our smaller customers where figures are compiled or gone over, but where an accountant does not feel that he can express any opinion and therefore disclaims one. We in the banks should be sufficiently familiar with our customers to have an understanding as to why an accountant disclaimed his opinion and we should be reasonable in our approach to that customer's credit problems. There is no reason why figures bearing a disclaimer cannot be accepted for credit purposes, provided the banker understands exactly why the disclaimer was issued, and is satisfied that the reason does not have significant bearing in the judgment of the credit-worthiness of the problem at hand. Bankers are much like CPAs in that we can only recommend the kind of audit our customers should have. I think that accountants have a responsibility to discuss with their clients the reasons for having an audit and the purposes for which the report is intended, and then recommending to them the type of examination appropriate to the opinion required.

However, neither the CPA nor the banker can force the client to agree. We in the banks can insist on certain types of audits or unqualified opinions only in those cases where we are prepared to lose business unless our demands are met.

Credit Standards

Frankly, that brings us face to face with the question as to whether a decision regarding the credit-worthiness of the potential borrower is seriously affected by the type of opinion his statement bears. If we feel that it is basic that we have the type of opinion we want, and he will not agree to obtain it for us, then I believe that is the type of credit application we should turn down whether or not we lose the business. How far one goes in lowering standards in order to hold business is a matter of individual judgment. However, while I know that there are exceptions in my own bank and in almost all other banks, I do not think that we should go too far in lowering the credit standards purely to keep an account on our books. When we grant credit on an unsatisfactory basis, when we make a bad loan, we are doing neither ourselves nor the customer any good. I have always assumed that a client pays an accountant's fee because he wants the assurance of having an expert outsider look at his financial position or because he needs the audit for credit purposes, or for a combination of both reasons. Why the client is willing to settle for an opinion that is unsatisfactory in the eyes of his accountant or in the eyes of his banker, I am unable to understand. Supposedly, he is as interested as is his banker in the quality of the auditing work done on his behalf and in the adequacy of the opinion expressed in connection with it.

The Letter of Transmittal

There is one point on which I feel quite strongly, and that is what may be referred to as a Letter of Transmittal. By that I mean the letter, which is part of the report, in which an accountant comments as to the scope of his examination and often outlines the ac-

counting procedures followed, but in which he nevertheless neither expresses an opinion nor disclaims one. When this happens, the reader is left entirely on his own to judge the adequacy with which the examination was made and whether or not the report is technically satisfactory for the purposes for which it was intended. It is my personal opinion that such reports should not be used for credit purposes, since it is impossible for the banker to gather from them any impression of the accountant's feeling with regard to the fairness of the presentation or the extent to which items were verified, or values established. There is a very real question in my mind as to the value of such a report to the client. If an accountant is adhering strictly to the principles of Auditing Bulletin No. 23, he will not issue such a report since Bulletin No. 23 expressly requires that the accountant express an opinion, qualified or unqualified, or a disclaimer. If a disclaimer is issued, the CPA must also set forth the reasons for submitting a disclaimer. I would urge all CPAs and all bankers to promote the principles of Bulletin No. 23 at all times. If we do so conscientiously, from day to day, this so-called Letter of Transmittal type of report should disappear from our scene.

Standards of Independence

I know many CPAs will not agree with me, but I think of independence as a two-pronged affair. One is an independence of mind and action in performing an audit and issuing an opinion; the second is independence of financial interest or considerations in connection with a client. One statement which came to my desk recently contained several pages on which the CPA outlined in detail the extent of the audit and commented on auditing standards, consistency and even the fairness of the figures; but he then went on to say that no opinion could be expressed because two partners in the CPA firm each owned a 10 per cent interest in the client. Since this statement was being given to us to be used as a basis for bank credit, we had to decide whether or not we considered it suitable for that purpose. Certainly, the disclaimer was based not on any reservation as to scope or quality of the audit, but rather appeared to rest entirely on the financial interest which two partners in the accounting firm had in the client.

There appears to be a divergence of standards in the accounting field in this connection. One set holding that an immaterial financial interest in a client does not constitute sufficient justification for disclaimer or qualified opinion, but merely that the existence of such interest should be disclosed. On the other hand, another authoritative set of standards (established by the U. S. Securities and Exchange Commission) disqualifies an accountant who has any financial interest whatsoever in a client. It seems to me that the latter view, while more drastic, is the better one since it is entirely clear in definition. It would appear to be very difficult to arrive at a decision as to what degree of financial interest is bad and what lesser degree is acceptable. This matter, of course, ties into the second prong of my version of independence and the matter of its very positive and unqualified definition.

With this point of view established, several of the banks, including my own, asked our customer to retain a new and totally independent firm to do its work. The new firm, without question, will find little to criticize in the work done by its predecessor, but it is unfortunate that the management and the original firm of accountants, knowing that the report was to be used for bank credit purposes, did not ascertain in advance of the engagement that a statement bear-

ing the disclaimer would not serve satisfactorily for that purpose.

A further question on the subject of independence arises in connection with the individual practitioner or small firm which has only two or three clients. Naturally, retention of the business of those clients is extremely important; and yet, if the CPA is to be truly independent, the wishes of those clients, where they in any way clash with the principles and standards of the accounting profession, must be denied. With the widening acquaintanceship between bankers and CPAs, which I hope and believe is being given increased momentum through our joint meetings, we all are having a greater opportunity to explore each other's viewpoints and to have a better understanding of each other's problems. During these discussions both banker and accountant should speak openly with regard to their beliefs as to how far the banker should go in this regard. Certainly, where the wishes of a client result in an effect on the figures which is entirely immaterial and the accountant qualifies his certificate but points out that such factors are negligible, the banker should not insist that the qualification be removed. The really important point is that the qualification is made, the opinion is expressed, and the fact that the items involved are immaterial to the general situation, is the important thing. I feel that we are making good progress in this area and will continue to do so in the future.

The accounting profession has fine standards of conduct and ethics. The profession's ideals are high and the CPA's work and word are justifiably respected. It is up to us, the bankers, who use the product of your efforts, to understand what you tell us or do not tell us. It is up to us to use every effort to convince our customers, who are your clients, to give you assignments which will enable you to express the kind of opinions both you and we consider necessary for the purposes of the examination.

When Does A CPA Disclaim An Opinion?

The CPA should not express an opinion that financial statements present fairly financial position and results of operations in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary to express an opinion on the statements taken as a whole. In such circumstances, whenever the CPA permits his name to be associated with financial statements, he should state that he is not in a position to express an opinion on the statements taken as a whole and should indicate clearly his reasons therefor. . . . It is not contemplated that the disclaimer of opinion should assume a standardized form. Any expression which clearly states that an opinion has been withheld and gives the reasons why is suitable for this purpose. However, it is not considered sufficient to state merely that certain auditing procedures were omitted, or that certain departures from generally accepted accounting principles were noted, without explaining their effect upon the CPA's opinion regarding the statements taken as a whole. . . .

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U. S. Income Taxation of Citizens Employed Abroad

By Arthur Wittenstein

This article analyzes in detail the rules under which United States citizens employed in foreign countries or Puerto Rico may exclude from U. S. taxable income amounts earned abroad. Problems relating to returns, declarations of estimated tax and withholding are also discussed.

Under Section 911 of the Internal Revenue Code, a citizen of the United States who receives compensation for services rendered in a foreign country or countries may, under certain conditions, exclude such compensation from gross income for U. S. income tax purposes. Important tax savings may accordingly be achieved by citizens employed abroad who meet the requirements of Section 911. The amount of any tax saving resulting from the application of this section will, of course, depend on the amount of foreign income taxes, if any, to which the individual employed abroad is subject. If the rate of foreign income tax is high, relatively little saving will have been achieved since the effect of the exclusionary provisions of Section 911 is to leave the individual subject to foreign income taxes only, rather than subject to U. S. income tax with an offsetting foreign tax credit.

It may be seen, therefore, that Section 911 is not required in order to eliminate double taxation. The foreign tax credit provisions of the Code accomplish this. Rather, the purpose of the statute is to place the American citizen employed in a foreign country on substantially the same footing taxwise as foreigners employed there. "It is demonstrable from the history of that legislation that the exemption was made in the interest of foreign trade, to induce Americans to accept employment abroad and put American business on an equality with foreign competitors."[1]

Nature of the Exclusion

Consistent with its purpose, the exclusion from U. S. gross income under Section 911 relates to earned income only, that is, compensation for personal services rendered in a foreign country or countries. The exclusion may be different as between citizens who establish a bona fide residence in a foreign coun-

Arthur Wittenstein *is associated with the firm of Lybrand, Ross Bros. & Montgomery, Certified Public Accountants. He is a contributor to* Montgomery's Federal Taxes *and has also contributed to the* Tax Law Review *and the* Journal of Accountancy.

try and citizens who are present in a foreign country or countries for extended periods without establishing residence, because of limitations which may be applicable in the latter case. No deduction is allowed on the U. S. tax return for expenses "properly allocable to or chargeable against"[2] the excluded income, but personal items such as medical expense and real estate taxes on a residence may be deducted under the general rules. The exclusion is not available with respect to compensation paid by the United States government or any agency thereof.

The exclusion rules do not apply with respect to U. S. resident aliens. However, such persons may obtain the benefit of the foreign tax credit for income taxes paid to foreign countries if the requirements of Code Section 901(b)(3) are met.

The exclusion rules based on residence in Puerto Rico are discussed later in this article.

Bona Fide Residence in a Foreign Country

If a citizen establishes that he is a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, all earned income received for services rendered abroad attributable to the period of foreign residence is excluded from gross income under Section 911 (a) (1) of the Internal Revenue Code. The time and place of receipt are immaterial so long as the services are rendered abroad. Territories and possessions of the United States, such as Alaska, Hawaii, Puerto Rico, the Virgin Islands and the Panama Canal Zone are not considered foreign countries for purposes of the residence test. Okinawa and the Philippines are foreign countries, however.

What constitutes the establishment of bona fide residence in a foreign country is discussed in Revenue Ruling 55-171 (1955-1 C. B. 80) as follows:

> No specific rule can be stated for determining whether a United States citizen is a bona fide resident of a foreign country, since it involves his intentions with respect to the length and nature of his stay. The intention of the taxpayer to establish a bona fide residence in a foreign country may be evidenced by words and acts, but where they conflict, more emphasis will be placed on the acts than on the words. Generally, a citizen who goes to a foreign country for a definite purpose, which is of a temporary nature, and who returns to the United States after it has been accomplished, is not a bona fide resident of such foreign country. However, if his purpose is of such a nature that an extended and indefinite stay may be necesssary for its accomplishment, and to that end he establishes residence in the foreign country, he may be a bona fide resident of such foreign country for Federal income tax purposes. For example, American citizens who go to foreign countries to work on construction projects, which are obviously of a temporary nature, cannot be classified as bona fide residents of such countries even though they remain abroad for an entire taxable year or longer. . . . However, citizens of the United States who are permanently assigned to foreign divisions of business concerns and who establish and maintain their residence in a foreign country or countries for a period of indefinite duration may be classified as bona fide residents of a foreign country or countries. . . .
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> Once bona fide residence in a foreign country or countries has been established, temporary visits to the United States or elsewhere on vacation or business trips will not necessarily deprive the citizen of his status as a bona fide resident of a foreign country. . . . Such absences must not be unreasonable in length, there must be full intention on the part of the individual to return to his foreign post, and there must be substantial evidence that the foreign residence has not been relinquished. Long periods of time spent in the United States or any possessions thereof would be considered as evidence that the citizen had relinquished bona fide residence in a foreign country.

The Period of Bona Fide Residence

While a trip to the United States or elsewhere may not affect the status of an

individual as a resident of a foreign country, compensation for personal services rendered within the United States on the occasion of such a trip is fully subject to U. S. tax. However, compensation for services rendered outside the United States during a temporary absence from the foreign country of residence is not subject to U. S. tax. The exclusion from gross income applies whether such services are rendered in another foreign country, or in a possession of the United States.

The requirement that the individual must be a resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year may be illustrated by the following examples.

1. A, a U. S. citizen who reports his income on the calendar year basis, takes up residence in France on January 5, 1956 and resides there without interruption until December 31, 1956, when he returns to the United States. Since the period of foreign residence does not include an entire taxable year, no exclusion is available.

2. Same as (1), except that A's residence terminates on December 29, 1957. No exclusion is available *on the basis of residence* since the period of foreign residence does not include an entire taxable year.

3. Same as (1), except that A's residence commences on December 1, 1956 and terminates on January 31, 1958. Since A is a foreign resident for an uninterrupted period which includes his entire taxable year 1957, all compensation received by him attributable to the fourteen-month period of foreign residence is exempt from U. S. tax.

It was recently held that the term "entire taxable year" means a full twelve-month period and that the exclusion was not available with respect to a shorter taxable period resulting from the taxpayer's death while residing abroad.[3]

Presence in a Foreign Country

Citizens of the United States who cannot meet the foreign residence requirements may still, under Section 911 (a) (2) of the Code, exclude income earned for services rendered abroad from gross income, provided they are present in a foreign country or countries for a total of 510 full days (approximately seventeen months) out of a period of eighteen consecutive months. In such case, however, the exclusion cannot exceed $20,000 for a taxable year, or if the eighteen-month period includes only part of a taxable year, the proportionate part of $20,000 which the number of days in the eighteen-month period within the taxable year bears to the total number of days in such taxable year.

As in the case of residence, a possession of the United States is not considered a foreign country for purposes of meeting the presence test, although income earned in a U. S. possession at any time during a period of eighteen consecutive months in which there were 510 days of foreign presence would be excludable from U. S. gross income. For example, if a U. S. citizen takes up employment in Venezuela on January 1, 1956 and remains there until June 30, 1957, except for a two-week business trip to Puerto Rico during that period, all of the income earned during the eighteen-month period will be exempt from U. S. tax because the individual will have been present in a foreign country (Venezuela) for more than 510 days in the eighteen-month period and all of the compensation earned during the eighteen-month period will have been for

services rendered outside the United States.

If, say, three months were spent in Puerto Rico during the January 1, 1956-June 30, 1957 period and the individual returned to the United States at the end of the period, no part of the compensation for services rendered abroad during such period would be excludable since less than 510 days would be spent in a foreign country. Only if the individual were considered a bona fide resident of Venezuela for the eighteen-month period, assumed to cover his entire 1956 taxable year, could the amounts earned abroad during such eighteen-month period (including the three months in Puerto Rico) be excluded from gross income.

Computing 510 Days

The 510 "full days" during which an individual must be physically present in a foreign country or countries in order to qualify for the exclusion must be continuous periods of twenty-four hours commencing from midnight and ending with the following midnight. If an individual travels over international waters from one place in a foreign country to another place in the same country, or to a place in another foreign country, and if such travel extends over a period of less than twenty-four hours and does not involve travel within the United States or any U. S. possession, the individual is deemed not to be outside a foreign country during the period of such travel. It apparently makes no difference whether such travel is by ship or air. If an individual sails from Italy at 10 P.M. on July 20 and arrives in France at 7 A.M. on July 22, three days are lost for purposes of the 510-day computation.

The exclusion from gross income applies to any period of eighteen consecutive months during which the individual satisfies the 510-full-day requirement, even though such period constitutes a part of a longer period of presence in a foreign country or countries. The eighteen-month period need not necessarily commence with the day of arrival in a foreign country, nor terminate with the day of departure therefrom. Thus, if the 510 days are consecutive, the individual may meet the eighteen-month requirement by including the month before arrival or the month after departure or any combination of either.

The Eighteen-Month Rule

The application of the eighteen-month rule may be illustrated as follows: A citizen who arrives in a foreign country on January 1, 1956, and finally departs therefrom on April 30, 1958, may not be present in such country for 510 full days during the eighteen-month period commencing with January 1, 1956 and ending with June 30, 1957, because of his visits to the United States during such period. However, he may satisfy the 510-day requirement during the eighteen-month period commencing with March 14, 1956 and ending with September 13, 1957. In such event, the exclusion will apply to income attributable to the latter period, but not to income attributable to the period commencing with January 1, 1956 and ending with March 13, 1956.

Whether the exclusion will also be available with respect to any period subsequent to September 13, 1957 depends on whether 510 days within some eighteen-month period ending after that date are spent in a foreign country. Any later eighteen-month period, although overlapping earlier ones, would be considered separately in determining whether 510 days of foreign presence have occurred within it.

Prorating the $20,000 Exclusion

As indicated above, the maximum amount excludable for each taxable year is $20,000 where the exclusion is based upon presence in a foreign country or countries. Where only a part of a taxable year is included in the eighteen-month period, the $20,000 amount is scaled down proportionately. The application of the maximum exclusion rule may be illustrated as follows.

Assume that A, a U. S. citizen who is compensated at a rate in excess of $20,000 a year, is present in England beginning October 1, 1956 and remains there without interruption until June 30, 1958, a period of 21 months. The maximum exclusion for the calendar year 1957 is $20,000. The maximum exclusion for 1956 is understood to be approximately 4/12 of $20,000. Since A will have been in a foreign country for 510 consecutive days commencing with October 1, 1956, his eighteen-month period of foreign presence may be considered to have commenced approximately one month prior to his actual arrival. The inclusion of this additional month as part of the eighteen-month period increases the number of days in the numerator of the fraction (the denominator being 365 or 366) which is applied to the $20,000 amount to determine the excludable portion of $20,000.

Actually, for the purpose of determining the exact number of days in the numerator, the eighteen-month period will be counted back by months from the time 510 consecutive days of foreign presence are first completed. From the earlier date so arrived at, the number of days in 1956 to December 31, 1956 will be counted. It may be seen that the number of days in the numerator will exceed by a few the number of days from September 1 to December 31. For example, if 510 days of foreign presence are first completed on February 22, 1958, the eighteen-month period will be deemed to commence August 23, 1956. Similar rules would be operative with respect to the termination of the eighteen-month period in 1958.

Time of Receipt of Income

As in the case of foreign residence, the place of receipt of payment for services rendered abroad is immaterial. However, the time when payment is made may have an important bearing on the availability of the income exclusion where such exclusion is to be based on presence in a foreign country or countries, rather than residence.

Under the rule relating to presence in a foreign country, no part of the exclusion is available for any taxable year of an individual unless some part of the eighteen-month period falls within the taxable year. Therefore if an employee, presumed to be on the cash and calendar-year basis for income tax reporting, receives payment for services rendered abroad in a year subsequent to the year in which the eighteen-month qualifying period was terminated, the amounts received are fully taxable. If, for example, the U. S. citizen with a qualifying period of foreign presence ending December 28, 1957 receives some portion of his compensation for services rendered abroad during such period in 1958 such compensation is taxable income to him in 1958 and no exclusion is available in computing his U. S. tax liability for that year.

Moreover, where the qualifying period ends in the year of payment, the exclusion for the taxable year is limited to the portion of $20,000 which the number of days in the eighteen-month period within the taxable year bears to the total number of days in such year.

Therefore, if an individual whose eighteen-month period expires, say, on January 5, 1958, receives payment in 1958 for services rendered abroad during 1957, his exclusion is limited to 5/365 of $20,000.

Considerable care with respect to the timing of payments to employees qualifying under the foreign presence rules must accordingly be exercised.

Residence in Puerto Rico

An individual U. S. citizen who is a bona fide resident of Puerto Rico during an entire taxable year may exclude income derived from Puerto Rican sources from his income subject to U. S. tax under Internal Revenue Code Section 933. Unlike the rules relating to the foreign country exclusions, the exclusion in this case applies not only to earned income but to dividends, interest, etc., derived from Puerto Rican sources. There is no maximum limitation on the amount excludable. Rules relating to deductions on the U. S. income tax return are the same as those applicable in the case of foreign country exclusions. The exclusion is not applicable with respect to compensation received as an employee of the U. S. government or any agency thereof.

In order for the Puerto Rican exclusion to apply, the individual must be a bona fide resident of Puerto Rico. Presence alone in Puerto Rico for any period will not qualify the individual for the exclusion. The rules relating to the establishment of bona fide residence in Puerto Rico are the same as those applicable to establishing residence in foreign countries, discussed above. It should be noted, however, that where an individual who is a resident of Puerto Rico performs services outside Puerto Rico during his period of residence, no exclusion is available with respect to compensation for such services even though the services are rendered outside the United States.

Unlike the rule applied in the case of an individual who is a bona fide resident of a foreign country for an entire taxable year, where the exclusion is applicable to the entire period of foreign residence, no exclusion is available for the taxable year in which an individual takes up residence in Puerto Rico, even if he remains in residence there throughout an entire taxable year. The same is true with respect to the taxable year of change of residence from Puerto Rico except that if the individual has been a resident of Puerto Rico for a period of at least two years before the date on which he terminates residence there, the exclusion is available in the taxable year of change with respect to income from Puerto Rican sources attributable to the residence period before the date of change.

Time of Receipt of Puerto Rican Income

While place of payment is immaterial with respect to the individual resident in Puerto Rico, the time of payment, as may be seen from the preceding discussion, is most important. Since no exclusion is available to the individual for the year in which he takes up residence in Puerto Rico, if payment for his services is deferred to a subsequent taxable year during which he is resident in Puerto Rico for the entire period, such deferred amount will qualify for the exclusion. It is likewise important, from the exclusion standpoint, that compensation be paid the individual during a period in which he is resident in Puerto Rico for a full taxable year rather than a year in which he changes his residence from Puerto Rico, unless he meets the two-year residence test which will qualify him for the exclusion. Even in that

case, if payment is made subsequent to the year of change of residence, the exclusion may be lost. This point is doubtful.

Where payments for services rendered are deferred to a subsequent period, it is desirable that the employee have no right to draw upon such amounts in the earlier year in order to strengthen his case against possible application of the "constructive receipt" doctrine. Application of the constructive receipt rules would result in taxing the individual as if he had actually received the income in the earlier year.

Employment in Other U. S. Areas

United States citizens employed or residing in Alaska or Hawaii are subject to U. S. income tax in the same manner as residents of any state. United States citizens working in the Virgin Islands are also subject to full U. S. tax rates although the tax on income earned in the Virgin Islands would be paid directly to the Virgin Islands government with a credit for such tax allowed on the U. S. tax return. However, U. S. citizens employed in the Panama Canal Zone, Guam, Samoa, Wake or the Midway Islands may exclude from U. S. taxable income amounts derived from outside the United States if the requirements of Code Section 931 are met.

Effect on Filing of Income Tax Return

Ordinarily a citizen of the United States, wherever resident, who has gross income of $600 or more (other than income excluded by law) must file an individual U. S. income tax return. No return is required of an individual whose income is excluded from gross income on the basis of foreign residence or presence, or residence in Puerto Rico, as discussed above, if the individual has less than $600 of includible gross income. However, the statute of limitations with respect to the assessment of deficiencies in tax does not commence to run until a return is filed.

If a citizen employed in a foreign country has not been there long enough to qualify for an earned income exclusion at the time his income tax return is due to be filed, but expects to qualify subsequently on the basis of continued residence or presence, he must either include the compensation in his gross income and pay the tax due thereon, or obtain an extension of time for filing his return. If he elects to include the compensation in his gross income and pay the tax, he may, after he has met the statutory requirements for exemption, file an amended return or a claim on Form 843 for refund of any tax thus overpaid. In order that it be timely, the amended return or refund claim must be filed within three years from the time the return was required to be filed (determined without regard to any extension of time) or two years from the time the tax was paid, whichever of such periods expires later.

The foregoing may be illustrated by the following example. A U. S. citizen is a bona fide resident of a foreign country from November 1, 1956 through January 31, 1958, during which period he performs personal services abroad. He would be required to include in his 1956 return, filed on the calendar year basis, all income for the year including the earned income received during the period November 1, 1956 through December 31, 1956, since he would not have met the exclusion requirements as of the due date for filing the 1956 return. However, since the exclusion requirements would be met as of December 31, 1957, he would then be entitled to a refund for the overpayment of tax resulting from the inclusion of the earned income for the November 1-De-

cember 31, 1956 period. A claim on Form 843 or an amended return should then be filed.

Citizens of the United States who, on April 15, are residing or traveling outside the United States are automatically allowed an extension of time until June 15 for filing the return for the preceding calendar year. A taxpayer who takes advantage of this extension must attach a statement to his return showing that he was residing or traveling outside the United States on the original due date, and he must pay interest at the rate of 6 per cent per annum on the unpaid tax, if any, from the due date until paid.

An extension of time for filing income tax returns may be granted for more than six months (the maximum period of extension generally permitted) in the case of citizens who are abroad. An individual desiring an extension of time, in addition to the two months automatically granted, for filing his return until after the completion of a qualifying period should make application therefor with the District Director of Internal Revenue with whom the return is required to be filed. The application must be in writing, properly signed by the taxpayer or his duly authorized agent and must be made before the due date (giving effect to previous extensions) for filing the return with respect to which the extension is requested. The application should set forth the facts relied upon to justify the extension of time requested and should include a statement as to the earliest date the taxpayer expects to be in a position to determine whether he will be entitled to the exclusion. The District Director with whom the return is required to be filed is the District Director for the district in which the taxpayer's legal residence in the United States is located, or if he has no legal residence in the United States, the District Director of Internal Revenue, Baltimore 2, Maryland.

Where the individual expects subsequently to complete a qualifying period and obtain the exclusion, it is generally advisable to apply for the extension of time for filing the return rather than to pay the tax and file a claim for refund later. Where, however, the taxpayer has other income for the year upon which a tax will have to be paid, the interest penalty can be avoided only if the taxpayer pays the tax on the original due date. It is believed that valid payment of tax may be made on the due date although an extension of time for filing the return has been applied for or is in effect.

The matter of returns discussed above in relation to a qualifying period would, of course, have no application to individuals resident in Puerto Rico since the exclusion rules differ in that case.

Declarations of Estimated Tax

A citizen of the United States, wherever resident, is required to file a declaration of estimated tax if his gross income (exclusive of income exempt from tax) can reasonably be expected to exceed amounts specified in the Internal Revenue Code. Income which it is reasonable to believe will be excluded from gross income based upon residence or presence abroad need not be taken into account for declaration purposes. If it should develop, however, that an individual as a result of transfer, death, etc., should fail to complete a qualifying period which he expected to complete, and upon which his instalment payments if any, under the declaration were based, with the result that the income excluded from the declaration became subject to U. S. tax in sufficient amount, liability for an addition to the tax at the rate of 6 per cent per annum upon the

amount of the underpayment for the period of the underpayment would presumably be incurred, subject to the regular rules applicable in the case of declarations.

A U. S. citizen who is traveling or residing abroad on April 15 is automatically allowed an extension of time to June 15 for filing a declaration and paying on that date, without interest, all instalments of estimated tax then due.

Income Tax Withholding

No withholding of U. S. income tax is required in any case where the employer, at the time of payment of remuneration, is required by the law of any foreign country or possession of the United States (including Puerto Rico) to withhold income tax on such remuneration. Accordingly, there is no double withholding of U. S. and foreign (or possession) income taxes. Mere agreements between the employer and the employee whereby the estimated income tax of a foreign country or possession is withheld from the remuneration in anticipation of actual liability under the laws of such country or possession, where such withholding is not actually required under the laws of the foreign country or possessions, will not suffice to relieve the employer from withholding U. S. tax.

In addition, no withholding of U. S. income tax is required where, at the time of payment of remuneration it is reasonable for the employer to believe that such remuneration will be excluded from gross income on the basis of a period of foreign residence or presence, or that the employee will be a bona fide resident of Puerto Rico during the entire taxable year.

The Treasury Regulations (Reg. 120, Section 406.226) provide that the employer may, in the absence of cause for a reasonable belief to the contrary, presume that remuneration for services performed outside the United States during the taxable year, or applicable portion thereof, will be excluded from gross income on the basis of foreign residence or presence, for each taxable year in respect of which the employee properly executes and files in duplicate with the employer a statement claiming such exclusion benefits. Forms for such statements, in the case of both foreign residence and foreign presence, are prescribed by the Regulations. The original of each such statement filed with the employer should be transmitted to the District Director of Internal Revenue with the employer's return on Form 941 for the quarter of the calendar year within which such statement is filed. The duplicate copy should be retained by the employer.

In the case where the exclusion is based on foreign presence, where the \$20,000 maximum limitation may be applicable, the Regulations provide that the above-stated presumption shall not apply after the total payments made during the taxable year of the employee equal \$20,000 or such lesser amount as may be allowable on the basis of the statement submitted by the employee.

In the case of foreign residence where with respect to an employee, the employer was entitled to presume for the two consecutive taxable years immediately preceding the employee's current taxable year that the exclusion was applicable, the employer may, if such employee is residing in a foreign country on the first day of such current taxable year, presume that such exclusion will apply to the current taxable year, in the absence of cause for reasonable belief to the contrary. Accordingly, no statement by the employee would have to be filed.

With respect to an individual employed in Puerto Rico, the Regulations

provide that the employer may, in the absence of cause for a reasonable belief to the contrary, presume that an employee will be a bona fide resident of Puerto Rico during the entire taxable year in every case except where the employee is known by the employer to have maintained his abode at a place outside Puerto Rico at some time during the current or preceding taxable year. Even in the excepted case, the employer is entitled to make the presumption of residence where the employee files with the employer a statement (containing a declaration under the penalties of perjury that such statement is true to the best of the employee's knowledge and belief) that such employee has at all times during the current calendar year been a bona fide resident of Puerto Rico and that he intends to remain a bona fide resident of Puerto Rico during the entire remaining portion of such current calendar year.

The compensation of U. S. citizens employed abroad by United States employers is subject to the Federal Insurance Contributions Act. Accordingly, withholding of such taxes is required in the same manner as if the employees were working in the United States. Such compensation is not, however, subject to the Federal Unemployment Tax Act.

A United States parent corporation may enter into an agreement with the Treasury under which F.I.C.A. coverage is extended to U. S. citizens employed abroad by its foreign subsidiaries. No withholding of F.I.C.A. tax from the employee is required in this instance.

Foreign and Puerto Rico Income Taxes

In effect, income taxes imposed by a foreign country or U. S. possession on a United States citizen may be claimed by the individual as a credit against his U. S. tax liability only to the extent that the individual has U. S. taxable income from sources within that country or possession. The credit with respect to any country or possession is limited under the Internal Revenue Code to the U. S. income tax otherwise determined, multiplied by a fraction the numerator of which is the taxable income derived from sources within such country or possession and the denominator of which is the taxpayer's taxable income from all sources.[4] Where all of a taxpayer's income from a foreign country or possession is excluded from U. S. taxable income, the numerator of the fraction is zero, so that no credit can be obtained.

Also, foreign income taxes on the excludable foreign income of U. S. citizens have been held nondeductible as taxes in computing U. S. taxable income as "properly allocable to or chargeable against" the excluded amounts.[5] Deductions falling in this category are specifically disallowed under Sections 911 and 933. Such taxes have also been held nondeductible under Section 265 which prohibits the deduction of expenses and interest allocable to tax-exempt income.[6]

References

1. *Swenson* v. *Thomas*, 164 F. (2d) 783 (5th Cir. 1947).
2. I. R. C., Sec. 911 (a) (1), (2). See also Reg. Sec. 1.911-1.
3. *Witt* v. *U. S.*, D. C. Ga., October 18, 1956.
4. I. R. C., Sec. 904 (a).
5. *Carstairs, Exr.* v. *U. S.*, 75 Fed. Supp. 683 (1936).
6. *George W. P. Heffelfinger*, 5 T. C. 985 (1945).

Part Two of a Three-Part Article

Tax Planning and the Stock Market

By ARTHUR J. DIXON, C.P.A.

Puts and Calls

Options to buy and sell securities are being used with increasing frequency by stock traders and investors. An option granted by one person to another to make the grantor accept certain stock at a fixed price within a stated period of time is a *put*. An option giving the holder thereof the right to make the grantor sell him certain stock at a fixed price within a stated period of time is a *call*.

Gain or loss on the sale of such options is capital gain or loss (long-term or short-term, as the case may be) if the property subject to the option is, or if acquired would be, a capital asset.[41] Puts and calls are, therefore, capital assets to traders or investors.

If an option is not exercised, it is treated as having been sold on the date of expiration.[42] Thus, if an option runs for six months and ten days, the loss on the expiration thereof is treated as a long-term capital loss. Suppose that the taxpayer has a six-month and ten-day option which, at the end of five months and twenty-five days, gives every indication that it will expire unexercised. (For example, a put at 60 when the market price after five months and twenty-five days is 70.) May the taxpayer at that point sell the option for a nominal price and realize a short-term loss? The question is not free from doubt, and there is no authority on the subject, but it is the writer's opinion that if the sale, although for a nominal price, is bona fide, a short-term loss should result. Section 1234 clearly indicates that a loss on an option is realized only on its sale or expiration. There is no provision for its worthlessness prior to expiration,[43] presumably because no option is totally worthless until it expires. It is true that, taking the above illustration, it is unlikely that the price of the stock will drop from 70 to less than 60 in fifteen days, but it is certainly possible. The possibility has value, and a sale at that value, as low as it may be, may nevertheless be a bona fide and loss-fixing event. The situation is in this respect different from the many cases denying loss deductions on the sales of securities which had previously become worthless.

If an option expires unexercised, the consideration received by the grantor of the option is, in all cases,. ordinary income to him.[44]

Puts and Calls and Short Sales

In discussing short sales, it was pointed out that a put acquired on the same day as stock identified to be used in exercising the put is not the equivalent of a short sale. If such a put expires, the cost thereof is not a deductible capital loss, but is added to the basis of the stock with which the option is identified.[45]

If a put or call option is exercised, the cost of the option is treated by both grantor and grantee as an adjustment of the cost of the stock transferred pur-

ED. NOTE: Part One of this article appeared in the December 1957 issue.

suant to the option.[46] Thus, if a call option is exercised, the amount paid for the call decreases the cost of the stock sold by the grantor of the option and, similarly, increases the cost of the stock to the grantee.

Put and call options have two additional tie-ins with the short-sale rules. If a taxpayer owns stock which, after he has held it for less than six months, has appreciated in value, he may not convert a short-term gain to a long-term gain by selling short and covering after the stock is more than six months old.[47] Suppose, however, instead of owning the stock outright, he owns a call. May he sell short against the call and still realize a long-term capital gain? The Internal Revenue Service has ruled that he may, holding that the call is not substantially identical to the underlying stock.[48] A taxpayer owning a call may, therefore, convert a short-term capital gain into a long-term capital gain, and, in a rising market, create artificial long-term gain and short-term loss.[49]

A taxpayer with a short-term gain may not convert it into long-term by acquiring a put on his stock because the put is the equivalent of a short sale.[50] Suppose the taxpayer sells a call on his stock, which call does not expire until after the stock is more than six months old. As a matter of practice, calls are generally not exercised until they approach their expiration date. If, at that time, the price of the stock has increased, the call will be exercised. The short-sale rules are not applicable and the taxpayer will have a long-term capital gain at the call price plus the consideration received for issuing the call.[51] If the price remains the same, the call will probably not be exercised. The taxpayer may, however, at that point sell his stock at the market and realize a long-term capital gain. The consideration received for the call will be ordinary income.[52] If the market price drops, the call will not be exercised. In that event, the taxpayer is economically protected to the extent of the consideration received for the call. Such consideration is ordinary income, but the taxpayer would have, in any event, realized a short-term gain if he had sold the stock instead of selling the call. The balance of the gain, if any, may be realized as a long-term gain by selling the stock at the market.[53]

Wash Sales

If a taxpayer sells stock or securities at a loss, but within a period beginning 30 days before and ending 30 days after the sale he acquires (by purchase or taxable exchange), or enters into a contract or option to acquire, substantially identical property, he has made a wash sale and the loss is disallowed.[54] In the case of taxpayers other than corporations, the wash sale rule is not applicable to security traders.[55] Corporations avoid the rule only if they are security dealers and then only with respect to transactions in the ordinary course of their dealer business.[56]

If a wash sale is made, the disallowed loss and the holding period of the stock or securities, the loss on the sale of which was non-deductible, is added to the cost basis and to the holding period of the stock or securities whose acquisition within the prohibited period caused the wash sale.[57] Because of these rules, it is possible that in certain circumstances, it may be desirable to create a wash sale. If, for example, a taxpayer realizes a loss which he determines, within 30 days, would result in bad timing of his capital transactions, he may, within the 30-day period, repurchase the stock or securities sold and eliminate the present deductibility of the loss. He is then in a position to deal with the new security just as if it were the old.

As pointed out in the previous discussion of short sales, the interpretation

of the phrase "substantially identical" has been quite troublesome. It has been held that approximation to identity and not mere similarity is the controlling issue.[58] Factors which have been considered in cases and rulings dealing with bonds include identity of the obligor, interest rates, maturity dates, issue dates, interest payment dates, the security behind the obligations, and the market values.[59]

In a recent unpublished ruling, the Internal Revenue Service took a very liberal view on the question of the substantial identity of two bonds. The bonds were practically identical in every respect except interest rates. They were issued by the same obligor, were payable out of the same revenues, and had the same interest payment dates, maturity dates and call dates. There was, however, a difference in interest rates of 3/8 per cent. This difference was enough, according to the Service, to make the bonds not substantially identical. The ruling states:

> "Securities are substantially identical when the par value, interest yield, unit price and the security behind the obligation are substantially the same. . . . It is the position of the Internal Revenue Service that two bonds of the same face amount issued by the same debtor but bearing different rates of interest are not substantially identical even though other features of the indebtedness are similar."

There is no indication in the ruling of the attitude of the Service on a difference in interest rates smaller than the 3/8 per cent involved in the particular facts. Nevertheless, it would seem clear that interest rates, though different, could be close enough to each other to make the instruments substantially identical.

Wash Sales and Options to Acquire Substantially Identical Securities

As pointed out above, if a taxpayer enters into a contract or option to acquire substantially identical property within the proscribed period, the wash sale rule is applicable. The acquisition of stock rights or stock warrants has been held to come within the definition of "options to acquire" which can result in the disallowance of a loss.[60] In a recent published ruling,[61] an interesting corollary question on stock warrants was discussed. It is clear that if stock is sold today and warrants on the stock acquired tomorrow, the wash sale rule is applicable because of the option acquisition.[62] Suppose, however, that stock warrants are sold at a loss and within 30 days the stock subject to the warrants is purchased. Is the loss on the sale of the warrants disallowed? The ruling states that, in these circumstances, the wash sale rule is inapplicable and the loss is allowable "unless the relative values and price changes are so similar as to make the warrants fully convertible securities and therefore substantially identical with the shares of common stock."

The implication is clear that if the stock is selling at a price above the price at which the warrants may be exercised, so that fluctuations in the price of the stock directly affect the value of the warrants and if, in fact, the market prices of the stock and warrants fluctuate proportionately to each other, the Internal Revenue Service would hold the two to be substantially identical property. Note, however, that in another ruling dealing with the question of substantial identity for short-sale purposes, the Service has held that a call is not the equivalent and is not substantially identical to the stock subject to call.[63] Both calls and stock warrants are, in essence, options to acquire stock or securities. The relative values and price changes of a call and the stock subject to call will be at least as similar as in a warrants-stock situation.

and a call is certainly fully convertible into the underlying securities in any reasonable interpretation of those words. These two rulings, therefore, seem completely inconsistent.[64]

Avoidance of Wash Sale Rule

The wash-sale rule is not applicable to bona fide sales at a profit, even though substantially identical securities are immediately re-acquired.[65] If a taxpayer has, for example, a capital loss carryover which is about to expire, he may "write up" his unrealized profits by selling the securities and quickly buying them back.

A loss is disallowed if a re-acquisition is made within 30 days before or after the sale. Suppose that the taxpayer buys 200 shares in one lot on January 4th and sells at a loss on January 5th 100 shares of the 200 acquired the previous day. Is the January 5th sale a wash sale? Applying the language of the Code section quite literally, an acquisition and disposition of the same 100 shares of stock within a 30-day period could be a wash sale.[66] This is obviously not the intended result, and the application in practice has always been that the repurchase must be in addition to the stock which was actually sold. Where 200 shares are acquired on one day and 100 shares are sold the next day, there has been an acquisition of an additional 100 shares. Nevertheless, the Service has ruled that the loss is not denied if the 200 shares are acquired in the same lot.[67] This is a liberal ruling, but seems to be in accordance with the intention of the law. Suppose that the 200 shares are acquired on the same day but in different lots? Or suppose 100 shares are acquired on January 4th, 100 shares are acquired on January 5th and 100 shares are sold on January 6th? Would the losses be denied in these circumstances and, if so, what would be the justification for differentiating them from the 200 shares acquired in one lot?[68]

Several means have been attempted to avoid the wash-sale rule. One approach has been to have a sale made by one taxpayer with a re-acquisition by a related taxpayer.[69] To the extent that these attempts have successfully avoided the wash sale rule, they now face the much more dangerous "indirect sale between related taxpayers" attack.[70] Another idea is through the use of short sales. As previously outlined, a short sale is not considered consummated for tax purposes until it is closed.[71] It has been suggested, therefore, that if a taxpayer wants to sell a security at a loss but to immediately re-acquire it, he should make a short sale. The short sale should be closed more than 30 days after the re-acquisition. Since such sale is considered consummated only on the later date, the re-acquisition has taken place more than 30 days before. This idea has a great deal of surface appeal, and it certainly complies with the letter of the law. Nevertheless, such a loss might very well be denied on the "no economic loss" theory which has been applied in a number of cases.[72] There is no direct authority in point, however. It has also been suggested that a put could be sold at a price above the market so that, unless the market price sharply increased, the put would be exercised and the stock sold back to the taxpayer more than 30 days after the loss sale.[73]

Sales Between Related Taxpayers

As discussed above, a wash sale merely postpones the deductibility of a loss. Losses on sales, direct or indirect, between certain members of a family or between a taxpayer and certain related entities, are, however, completely de-

nied.[74] The related purchaser uses his purchase price as his tax basis, without adding thereto the disallowed loss. The disallowed loss may, however, be offset against a subsequent gain realized by the purchaser.[75]

The hidden danger of this rule results from the fact that it is applicable to sales made either directly or *indirectly* between such parties. The Supreme Court, in the case of *McWilliams* v. *Commissioner*,[76] gave a very broad interpretation to the meaning of "indirect." In that case, a taxpayer, who managed his wife's property as well as his own, ordered his broker to sell certain stock held by one of them and to simultaneously purchase, at as nearly the same price as possible, the same stock for the other. This was done for the express purpose of establishing tax losses. Nevertheless, the stocks were sold and purchased on the stock exchange, to and from unknown parties, and different certificates were received. The Supreme Court held this to be an indirect sale between the husband and wife and the loss was disallowed.

A recent case has applied the same rule to stock exchange purchases and sales made by a mother and son.[77] The transactions were made by an investment counsel authorized to act for both parties. The number of shares sold for one and purchased for the other were different, some of the market prices were different, though not materially, and, in one case, there was a period of 27 days between the sale and the purchase. Nevertheless, the Court held the losses to be non-deductible. In such cases, it has been indicated that the safety period is more than 30 days, because, after that time, the taxpayer could have re-acquired the securities himself and still have a deductible loss.[78]

How far may this rule be applied? Suppose Brother A, living in New York, sells 100 shares of X stock through his broker on the New York Stock Exchange on March 2nd. Brother B, living in San Francisco, without any knowledge of Brother A's sale, purchases the same stock the next day through his San Francisco broker, but on the New York Stock Exchange. Would Brother A's loss be disallowed?[79] It would seem not. An indirect sale between two parties implies a knowledge and acquiescence, either actual or imputed, by each of the sale or repurchase made by the other. In the *McWilliams* and *Norton* cases, both parties to the transactions were represented by the same person. In the absence of such concerted action, there should be no holding of an indirect sale.

Identification of Securities

A simple and effective means of tax planning which is often overlooked is the identification of securities sold. If a taxpayer owns several blocks of stock, purchased at different prices and at different times, any sale of less than his whole position is governed by the first-in, first-out rule if the actual stock sold cannot be identified.[80] In the absence of identification, therefore, control of the gain or loss to be realized is taken out of the taxpayer's hands and adverse tax consequences may be suffered thereby. For example, a taxpayer with 200 shares of stock, 100 long-term and 100 short-term, both showing a profit, may want to realize a short-term gain because he had previously incurred a net long-term loss. He must, therefore, be able to identify the stock sold as being the stock which he has held for not more than six months. Otherwise, the long-term stock, which was the first acquired, will be deemed to have been sold.

With respect to stock held by the taxpayer, identification should be made by certificate number whenever it is possible to do so.[81] If lots presently held by the taxpayer are intermingled and no identification has been made, effective steps may still be taken. The dates on the certificates may indicate which certificate is attributable to which block. The taxpayer's records may now be amended to reflect the matching up of purchases with certificate numbers as so determined. If, for some reason, the dates on the certificates are not determinative, the taxpayer may now match his lowest certificate number with his earliest purchase and continue so matching with ascending certificate numbers and dates of acquisition in chronological order. After such matching, his records should be clearly maintained to reflect this identification.[82]

If a taxpayer intends to deliver one certificate but actually delivers another, his gain or loss will be measured by the certificate actually delivered rather than the one which was intended.[83]

Securities held in the custody of a stockbroker or other agent are easily identified. All that is required is a letter to the broker or agent instructing him to deliver the securities acquired at a particular date at a specified price.[84]

The mere intention to sell particular shares, without further designation is not sufficient identification.[85] Nor is the mere declaration that sales were of certain shares of different lots.[86] The entry of a sale against an arbitrarily selected purchase as shown in the ledger account is not satisfactory.[87] Bookkeeping entries alone are not enough.[88]

When the first-in, first-out method must be used, the rules are applied independently to the source from which delivery is made.[89] If, for example, a taxpayer actually has possession of certain lots of stock, while certain other lots are held by his broker, and delivery is made from the lots held by the taxpayer, the first-in, first-out rule is applied to those lots. On the other hand, if delivery is made from the stock held by the broker, the first-in, first-out rule is applied to the lots held by him.[90] First-in means the security first purchased and not the security first delivered into a particular account. For example, if a margin account contains stock acquired on January 1, 1957 and on February 1, 1957, and there is delivered into the account stock bought on January 1, 1956, the January 1, 1956 stock will be the first sold, in the absence of identification.[91]

Stocks or securities exchanged in a corporate reorganization or recapitalization may maintain their identification.[92] The Tax Court has accepted a method of identification of arbitrarily assigning the lowest numbered new certificate to the earliest lot purchased and the Commissioner has acquiesced in this method.[93] In the absence of identification, the first-in, first-out method is not applicable to new stocks or securities received in a different corporation as a result of a reorganization. The total cost of all of the old lots exchanged is divided and allocated equally to each of the new shares received.[94] In the case of a stock dividend or split up, or an internal recapitalization or reorganization involving only the stock or securities of the same corporation, the first-in, first-out method is still used, in the absence of identification.[95]

Stock Rights

The receipt of stock rights is usually tax exempt.[96] If such rights are permitted to expire unexercised, the expiration results in neither taxable gain nor deductible loss.[97] If the rights are sold,

there is a closed transaction, resulting in a gain or loss.[98] Whether such gain or loss is capital or ordinary in nature depends on whether or not the rights are held primarily for sale to customers in the ordinary course of the taxpayer's business. Rights held by a trader or investor are capital assets.[99] The holding period of rights which are sold includes the holding period of the stock with respect to which such rights are received.[100]

If rights are sold or exercised, an election exists with respect to the tax basis of such rights. If the fair market value of the rights at the time of the distribution is less than 15% of the fair market value of the old stock at such time, the basis of the rights is zero unless the taxpayer elects otherwise.[101] If the taxpayer makes such an election, or if the fair market value of the rights is 15% or more of the fair market value of the old stock, the tax basis of the old stock is allocated between it and the rights in proportion to the fair market value of each on the date of distribution.[102]

If the rights are exercised, the holding period of the new stock commences on the date of exercise.[103] If an allocation of basis to the rights is made pursuant to the previous paragraph, the basis of the rights is added to the basis of the new stock.[104]

If rights are actually purchased, rather than received with respect to old stock, they are treated as independent assets. The tax effects of their sale or expiration are governed by Section 1234, dealing with options to buy or sell property.[105] If such rights are exercised, the same rules apply as in the case of rights received with respect to stock held.

The rule in the 1954 Code that no basis need be attributed to rights worth less than 15% of the value of the old stock has given rise to an interesting tax-saving possibility. If rights with substantial value are to be issued, the stock may be acquired just before the ex-rights date and sold on or after the ex-rights date. The taxpayer then receives the rights, exercises them, and is issued the new stock. The difference between the market price of the stock before and after the ex-rights date will be, all other things being equal, the value of the rights. The taxpayer's purchase and sale will give rise, therefore, to a short-term capital loss. The new stock acquired pursuant to the exercise of the rights will have as its tax basis the subscription price because the taxpayer would not elect to allocate any part of the basis of the old stock to the rights. The difference between the subscription price of the new stock and the market value of the new stock generally works out to be the equivalent of the loss on the old stock. The new stock is held for more than six months and, assuming that the market remains the same, the taxpayer may then realize a long-term capital gain equivalent to his previous short-term capital loss. Of course, there is market risk involved in this transaction and it has been used only in situations such as the American Telephone & Telegraph Co., involving stable stock and rights with substantial value. It should also be noted that the wash-sale rule may be applicable.[106]

References

41. Section 1234, IRC.

42. Section 1234, supra.

43. Section 165(g), IRC deals with the treatment of worthless securities. Even if a put or call could be considered to be a security within the meaning of that section, which is very doubtful, the prescribed treatment of a sale or exchange on the last day of the taxable year of worthlessness is completely inconsistent with the provisions of Section 1234. It would appear that the two sections are mutually exclusive, and that options dealt with in Section 1234 are not affected by Section 165(g).

44. Regulation Section 1.1234-1(b). This conclusion is due to the fact that Section 1234 deals with gain or loss attributable to the sale or exchange of such options and loss on the failure to exercise them. No mention is made of gain resulting from the failure to exercise. Such gain is, therefore, includible in gross income under Section 61.

45. Section 1233(c), IRC.

46. IT 3835, 1947-1 CB 53.

47. See discussion of Section 1233, IRC, supra.

48. Letter ruling dated February 27, 1957, 575 CCH Para. 6332.

49. See the discussion in "Short Sales Can Still Transmute Short-term Calls Gains Into Long," 7 JTAX 14.

50. Footnote 29, supra.

51. Footnote 46, supra.

52. Footnote 44, supra.

53. It has been suggested that a taxpayer with a short-term gain sell a call substantially below the current market price in order to make it more certain that the call will be exercised so that he will realize a long-term gain. Example: Mr. Smith buys 100 shares of X Corp. stock at $30 per share on January 1st. On May 1st, the stock is worth $50 per share and Mr. Smith sells a call at $40. The purchaser of the call could realize an immediate profit of $10 per share. Therefore, he pays Mr. Smith $1,000 for the call. The call runs until at least July 2nd. If, on July 2nd, the market price of the stock has not dropped below $40 per share, the call is valuable and will be exercised. Mr. Smith will realize $4,000 on the exercise plus the $1,000 which he received for the call, and will have, it is suggested, a long-term capital gain of $2,000. The tax effects of this transaction have been informally discussed with the Internal Revenue Service, with inconclusive results.

54. Section 1091 IRC. As stated in the text, the wash-sale rule is applicable only to stocks or securities. It is not applicable to foreign moneys. IT 1552, II-1 CB 96; nor is it applicable to a commodity exchange membership. *Frederick R. Horne,* 5 TC 250. The courts are split as to whether commodity futures contracts come within the rule. The Sixth Circuit holds that they do. *Trenton Cotton Oil Co.* v. *Commissioner,* 147 F (2d) 33, 45-1 USTC Para. 9163 (6th Circuit 1945). To the contrary—*Corn Products Refining Co.,* 16 TC 395; *Corn Products Refining Co.* v. *Commissioner,* 215 F (2d) 513, 54-2 USTC Para. 66082 (2d Circuit 1954).

55. Regulation Section 1.1091-1(a). The reason for this conclusion is that Section 1091 states that "no deduction for the loss shall be allowed under Section 165(c)(2)." Section 165(c)(2) provides for the deductibility of "losses incurred in any transaction entered into for profit, though not connected with a trade or business." Business losses are deductible under 165(c)(1).

56. Regulation Section 1.1091-1(a).

57. With respect to basis, Section 1091(d), IRC. With respect to holding period, Section 1223 (4), IRC.

58. *Hanlin, et al, Executors* v. *Commissioner,* 108 F (2d) 429, 39-2 USTC Para. 9783 (3rd Circuit, 1939).

59. Municipal bonds of the same obligor and of the same value, differing only in dates of maturity (four to ten months) sixteen years in the future were substantially identical. So were Federal Land Bank bonds issued by the same Federal Land Bank and differing less than three years in dates of maturity. Not substantially identical were bonds of one Federal Land Bank as compared with bonds of another Federal Land Bank, because of differences in the collateral security underlying the bonds. *Hanlin et al, Executors* v. *Commissioner,* supra; bonds were not substantially identical where there was a difference in their dates of issuance of not less than four years and five months, a difference in their dates of maturity of not less than five years and five months, a difference in the dates upon which interest was payable, a difference of 1⅜ in the market price of the bonds, and one lot of bonds was registered while the other bore coupons. *Campbell,* 39 BTA 916, (Acq.); notes and bonds of the same corporation which differed with respect to interest rates, interest payment dates, and dates of issuance and maturity, were not substantially identical, though the notes were secured by the pledge of the bonds. GCM 21496, 1939-2 CB 169; Series A and Series B debentures of the same company were substantially identical. Both series had the same maturity date, the same interest dates, and the same rate of interest, the only difference being the dates of issue and amounts to be redeemed annually. IT 2778, XIII-1 CB 79; two bonds of the same face value issued by the same municipality at the same rate of interest but of different dates of issue, of interest payments, and of maturity, were not substantially identical. IT 2672, XII-1 CB 72; Second Liberty Loan 4¼% bonds and Fourth 4¼% Liberty bonds were not substantially identical, market values and dates of maturity being different. IT 1365-I-1 CB 151. In the case of stock, it has been held that voting trust certificates for common stock are substantially identical to the stock itself. *Kidder,* 30 BTA 59; on the other hand, Class A non-voting stock is not substantially identical with common stock of voting power. IT 2585, X-2 CB 182.

60. Rev. Rul. 56-406, supra. The same rule would appear to be applicable if a taxpayer actually purchases stock rights within 30 days of a sale at a loss. Suppose, however, that the taxpayer holds securities on which rights are issued by a corporation, the receipt of which is tax free to the taxpayer, and he has made a sale at a loss within 30 days of the issuance of the rights. It has been held that, where a taxpayer acquires stock through the exercise of subscription rights, and within 30 days after such acquisition sells an equal number of shares of the stock with respect to which rights were issued, the wash-sale provisions are applicable.

IT 2890, XIV-1CB 225. However, the mere receipt of the rights within the 30 day period without their exercise in the same period should not bring the wash-sale rule into effect. Section 1091(a) applies if the taxpayer "has entered into a contract or option so to acquire." The receipt of rights issued by a company does not appear to be the *entering into* of an option. Nevertheless, in a closely related situation, the Internal Revenue Service ruled that, for the purpose of Section 1091, "an employee of a corporation, who, under the terms of a restricted stock option plan, is granted an option to purchase stock of the corporation, will be held to have entered into the option to acquire stock on the date on which the option is granted him." Rev. Rul. 56-452, IRB 1956-37, 19.

61. Rev. Rul. 56-406, supra.

62. Footnote 60, supra.

63. Footnote 48, supra.

64. Footnote 49, supra.

65. IT 1239, I-1 CB 149.

66. Section 1091 states:

"In the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired . . . substantially identical stock or securities, then no deduction for the loss shall be allowed. . . ."

The acquisition of 100 shares of stock on January 1st and the sale thereof on January 3rd at a loss could, if the language was literally applied, fall within the section.

67. Rev. Rul. 56-602, IRB 1956-48, 80.

68. Rev. Rul. 56-602, supra, states:

"Subsequent Congressional discussions and reports refer consistently to the 'new acquisition' and to 'repurchasing' and 'buying back' of stock or securities. These terms indicate an intent on the part of Congress to prevent a taxpayer's taking losses for tax purposes while giving up his position in the security for only a few days or not at all. However, they do not indicate an intent to disallow a loss sustained in a bona fide sale of securities made to reduce the taxpayer's holding, even though the sale is made within 30 days after the securities were purchased."

Perhaps section 1091 should be amended to exclude losses on sales of securities held for not more than 30 days when the acquisition of the second lot was made within a certain number of days after the acquisition of the lot resulting in the loss.

69. Sale by husband and re-acquisition by wife does not result in a wash sale even though joint return is filed. *Gummey*, 26 BTA 894, (Acq.). But see footnote 74 infra, and the discussion to which it relates; similarly, as to taxpayer's son, *Cole* v. *Helburn*, 4 F Supp 230, 3 USTC Para. 1081 (W.D. Kentucky 1933), and to taxpayer's sister, *Commissioner* v. *Johnston*, 107 F (2d) 883, 40-1 USTC Para. 9108 (6th Circuit 1939); to the contrary, loss disallowed on the repurchase by a trust created by the taxpayer, and whose personal property was under the taxpayer's absolute domain. *Security First National Bank of Los Angeles et al*, 28 BTA 289; where a partnership sells stock at a loss and within 30 days before or after the date of the sale an individual partnership member acquires substantially identical stock with his own funds, the wash sale provisions apply to him. Special Ruling, October 11, 1946, 464 CCH Para. 6308; a repurchase agreement entered into at the time of sale, either express or implied, results in the disallowance of the loss. *Commissioner* v. *Dyer*, 74 F (2d) 685, 35-1 USTC Para. 9077 (2nd Circuit 1935).

70. Footnotes 74 and 75 infra and the discussion in connection therewith.

71. Footnote 23, supra.

72. In the case of *Frederick R. Horne*, supra, a membership on the New York Coffee and Sugar Exchange was sold and reacquired within a few days. The Court held that the wash sale rule was not applicable because the membership was not a stock or security. Nevertheless, the loss was disallowed because the realization thereof was not genuine and the taxpayer's position was unchanged. See also *Pierre S. Dupont*, 118 F (2d) 544, 41-1 USTC Para. 9299 (3rd Circuit 1941); *Shoenberg* v. *Commissioner*, 77 F (2d) 446, 35-1 USTC Para. 9333 (8th Circuit 1935).

73. Example: Mr. Smith bought 100 shares of X Corp. stock at 50. It is now worth 30 and he would like to take the loss but immediately establish his position. He sells a put on the stock at 40, for which he is paid $1,000. The put runs for more than 30 days. At the same time, he sells his stock at the market for a 20-point loss. If, at the time the put expires, the market price has not gone above 40, the holder will exercise the put. Mr. Smith will have to pay $40 per share to buy the stock. He had, however, previously received $10 per share when he granted the put. The repurchased stock has a net cost to him of $30 per share. Informal discussion has been had with the Internal Revenue Service as to whether, in its opinion, the result set forth in the example would follow. No conclusive answer was received.

74. Section 267, IRC.

75. Section 267(d), IRC.

76. 331 US 694, 47-1 USTC Para. 9289 (U.S. Sup. Ct. 1947). The same result followed, even though the purchase by one spouse preceded the sale by the other. *John B. & Gwendolen N. Shethar*, 28 TC —, No. 144.

77. *Richard W. Norton, Jr.* v. *U.S.*, 144 F. Supp 425, 56-2 USTC Para. 9940 (D.C. La. 1956).

78. In the Norton case, supra, the Court stated: ". . . We do not believe the loss would or could be disallowed if the purchase by the brother occurred more than 30 days after the sale, for if the seller himself may repurchase after that delay, without incurring disallowance of his loss, under the wash sale provision of the Internal Revenue Code . . ., he would be no less entitled to deduct the loss upon purchase of the same stocks by his brother after 30 days."

79. This possibility was posed by the taxpayer to the Court in the Norton case, supra. The Court answered: "We need not decide whether that necessarily would be the result (disallowance of a loss) under Section 24(b), but in answer to the argument we observe that such a factual occurrence hardly could happen absent prearrangement —concert of action."

This observation by the Court is unrealistic. Such purchases and sales by "family" members without prearrangement could, and undoubtedly have, occurred.

80. *Towne* v. *McElligott*, 274 F 960, 1 USTC Para. 52 (S.D. New York 1921); Proposed Regulation Section 1.1012-1(c)(1).

81. Compare *Davidson* v. *Commissioner*, 94 F (2d) 303, 38-1 USTC Para. 9082 (8th Circuit 1938) Cert. denied, 304 U.S. 569 with *Franklin*, 37 BTA 471 (Acq.); Proposed Regulation Section 1.1012-1(c)(2) (for which there was no precedent in prior regulations) states:

"An adequate identification is made if it is shown that certificates representing shares of stock from a lot which was purchased or acquired on a certain date or for a certain price were delivered to the taxpayer's transferee. . . ."

Paragraph (3) (ii) of the same proposed regulation provides:

"Where a single stock certificate represents stock from different lots, where such certificate is held by the taxpayer rather than his broker or agent and where the taxpayer sells a part of the stock represented by such certificate through a broker or other agent, an adequate identification is made if, at the time of the delivery of the certificate to the broker or other agent, the taxpayer—

(a) Specifies to such broker or other agent the particular stock to be sold or transferred, and

(b) Confirmation of such specification is set forth in a written document from such broker or agent.

Where part of stock represented by a single certificate is sold or transferred directly by the taxpayer to the purchaser instead of through a broker or other agent, an adequate identification is made if the taxpayer maintains a record of the particular stock which he intended to sell or transfer."

82. *Hitchcock* v. *U.S.*, 36 F Supp 507, 41-1 USTC Para. 9159 (E.D. Michigan 1940); Special Ruling, January 24, 1944, 443 CCH Para. 6130.

83. *Davidson, James E.* v. *Commissioner*, 305 US 44, 38-2 USTC Para. 9548 (U.S. Sup. Ct. 1938); Proposed Regulation Section 1.1012-1(c)(2).

The Davidson case applied this rule to an erroneous delivery by the taxpayer's broker or agent, contrary to the taxpayer's instructions. The proposed regulation, however, does not charge the taxpayer with such an error made by his broker or other agent if the terms of the regulation are complied with. See footnote 84, infra.

84. *Helvering* v. *Rankin*, 295 US 123, 35-1 USTC Para. 9343 (U.S. Sup. Ct. 1935); Proposed Regulation Section 1.1012-1(c)(3) adds the requirement of a written confirmation from the broker or agent. It provides:

"Where the stock is left in the custody of a broker or other agent, an adequate identification is made if, at the time of the sale or transfer, the taxpayer—

(a) Specifies to such broker or other agent having custody of the stock, through whom the sale or transfer of such stock is made, the particular stock to be sold or transferred, and

(b) Confirmation of such specification is set forth in a written document from such broker or other agent.

Stock identified pursuant to this subdivision is the stock sold or transferred by the taxpayer, even though stock certificates from a different lot are delivered to the taxpayer's transferee."

85. *John A. Snyder* v. *Commissioner*, 295 US 134, 35-1 USTC Para. 9344 (U.S. Sup. Ct. 1935).

86. *Mickler Holding Company*, 29 BTA 300.

87. IT 3426, 1940-2 CB 41.

88. *Mack*, 31 BTA 1149.

89. *Bancitaly Corp. et al*, 34 BTA 494 (nonacq.). Appeal to C.C.A.-9 dismissed, June 16, 1941.

90. *Forrester*, 32 BTA 745 (Acq.).

91. *Forrester*, supra. In determining which stock in a particular depository was first acquired, other problems arise. For example, with respect to stock received as a gift, it has been held that the date of acquisition is considered to be the same date on which the holding period for gain or loss purposes is deemed to commence. *Lunsford Richardson* v. *Smith*, 38-2 USTC Para. 9503 (D.C. Conn. 1938). On the other hand, the Tax Court has indicated that the "first in" shares are those purchased by the taxpayer, even though other shares in the depository were acquired earlier by gift. *Katherine J. Hanes*, 1 TCM 634. Another problem concerns stock acquired through the exercise of rights. Such stock should be considered as having been acquired when the rights were exercised. If rights issued in respect of different lots of stock are exercised at the same time, any sale of stock acquired through such exercise will be presumed made from stock acquired through rights issued in respect of the earliest acquired lot. GCM 11743, XII-2 CB 31.

92. *Bloch* v. *Commissioner*, 150 F (2d) 540, 45-2 USTC Para. 9395, (9th Circuit 1945); Rev. Rul. 55-355, 55-1 CB 418, as interpreted by a special ruling dated September 1, 1955, reproduced at 555 CCH Para. 6462. See also *Kraus* v. *Commissioner*, 88 F (2d) 616, 37-1 USTC Para. 9164 (2d Circuit 1937). Cf. *Arrott* v. *Commissioner*, 136 F (2d) 449, 43-1 USTC Para. 9478 (3rd Circuit 1943); *Big Wolf Corporation*, 2 TC 751.

93. *Ford, et al*, 33 BTA 1229 (Acq.).

94. *Commissioner* v. *Oliver*, 78 F (2d) 561, 35-2 USTC Para. 9536 (3rd Circuit 1935); Rev. Rul 55-355, supra.

95. *Alvin T. Fuller* v. *Commissioner*, 81 F (2d) 176, 36-1 USTC Para. 9058 (1st Circuit 1936); *Kraus* v. *Commissioner*, supra. To the contrary, *Big Wolf Corporation*, supra. In applying the first-in, first-out rule, new shares received in substitution for old shares are treated as having been acquired when the old shares were acquired. New shares received in addition to old shares, such as in the case of a stock dividend, are treated as having been acquired at the same time as the shares with respect to which they were received. O.D. 735, 3 CB 40. See Rev. Rul. 56-653, IRB 1956-51, 9, for an illustration of the identification of shares involved in a stock split.

96. Section 305, IRC. Rights to subscribe to bonds which are convertible into stock are also taxfree. *Powel*, 27 BTA 55 (Acq.); GCM 13275, XIII-2 CB 121.

97. Special Ruling, December 4, 1946, 474 CCH Para. 6090.

98. The rights are considered a separate asset to which the rules of subchapter O are applicable. See also *Myles* v. *Safe Deposit & Trust Co.*, 259 US 247, 1 USTC Para. 66 U.S. Sup. Ct. 1922).

99. Footnote 6, supra.

100. Section 1223(5), IRC.

101. Section 307(b), IRC.

102. Regulation Section 1.307-1(a).

103. Section 1223(6), IRC.

104. Regulation Section 1.307-1(b).

105. Footnote 41 and following supra, and the discussion in connection therewith.

106. On the question of whether the mere receipt of rights within 30 days of the sale of stock at a loss brings the wash sale rule into effect, see the discussion at footnote 60, supra. Of course, if the rights are exercised within the 30-day period, the wash sale rule is applicable. Usually, however the rights give the stockholder the privilege of buying one share for a specified number of old shares held, for example, one for ten. In that event, only a fraction of the shares sold will be reacquired and, therefore, only a fraction of the loss can be disallowed.

New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Personal Exemptions . . . Excludable Sick Pay . . . Change of Classification . . . Minimum Franchise Tax—Domestic and Foreign Corporations . . . Change in Classification . . . Another Aspect of Change in Classification . . . Exercise of Stock Option.

Personal Exemptions

A new income tax return for individuals has been prepared by the State Tax Commission. It reflects the 1957 amendments to the law as passed by the 1957 legislature. One of the amendments relates to an additional dependency credit of $400 allowed to a taxpayer who supports a dependent over 18 years of age who is in attendance full time at an approved school or college. The instructions indicate that the total exemption for such a dependent is $800. The taxpayer is requested to report separately (line 8a) dependents over 18 years of age and attending school. The details are reported in Schedule G.

Excludable Sick Pay

Compensation received while a taxpayer is absent from work on account of personal injuries or sickness is excluded from gross income. The law provides that such payments must be made under a wage continuation plan, an employee accident or health plan, or under an employer financed accident or health insurance policy. The amount excluded may not exceed $100 per week.

These provisions follow those in the federal code. If the absence is due to illness, no deduction is allowed for payments received for the first seven calendar days unless the taxpayer was hospitalized for at least one day during the illness. In the latter event the exclusion applies from the first day of absence.

The form provides that the total compensation be shown (line 10b) and the excludable portion separately reported (line 10c). The form requires a detailed explanation of the right to take the deduction, the computation of the amount deducted, the periods of absence, nature of the illness or injury and whether the taxpayer was hospitalized.

Change of Classification

Two stockholders own equally all the stock of a business corporation and also own all the stock of a real estate company. The business corporation admittedly uses a material part of the property of the real estate company in the conduct of its business.

In the above situation the real estate corporation becomes taxable under

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BENJAMIN HARROW, C.P.A. *and member of the New York Bar, has been a member of our Society since 1928. Formerly a Professor of Law at St. John's University, Mr. Harrow is a past vice-president of our Society. The committees of his present or past service, as member or chairman, include Federal Taxation, New York State Taxation and Estate Planning. He is engaged in practice in New York City.*

Article 9A as a business corporation. Section 211.4 of the tax law covers this situation. Whenever substantially all the capital stock of a real estate corporation and a business corporation is *owned or controlled directly or indirectly by the same interests,* and any material part of the property of the real estate corporation is used or occupied in the conduct of the business of the business corporation, the real estate corporation becomes taxable as a business corporation.

The meaning of substantially all the capital stock is defined in Article 560 of the regulations in connection with the filing of combined reports to mean the beneficial ownership or control of at least 95% of the issued and outstanding capital stock, entitling the holders to vote for the election of directors. The same definition would probably be relevant in connection with Section 211.4 of the law.

There is no guide in the law as to what constitutes a material part of the property of the real estate corporation. If a significant or important part of the property is occupied by the business corporation, the real estate corporation comes within this provision. The facts presented in each case would determine the issue.

In the case presented above, suppose one of the stockholders sells his 50 per cent interest in the real estate corporation to two individuals completely unrelated to the two stockholders in a bona fide, arms length transaction. Does that affect the classification of the real estate corporation? Yes.

After the sale of his interest by one of the stockholders, substantially all the capital stock of the real estate corporation and the business corporation is no longer owned or controlled directly or indirectly by the same interests. Therefore Section 211.4 no longer applies and the real estate corporation will be reclassified as a real estate corporation taxable under Section 182 of Article 9.

Minimum Franchise Tax— Domestic and Foreign Corporations

The mere possession of the privilege of exercising its franchise subjects a domestic corporation to the franchise tax. That is so whether or not the domestic corporation actually utilizes such privilege by doing business. That is why the Tax Commission keeps after all inactive or dormant companies for reports and for the payment of the minimum tax.

With respect to a foreign corporation the situation is different. Such a corporation is subject to the tax only if it exercises the privilege of doing business within the state, even if it has not qualified formally to do business in New York. The bare right to be a corporation is not something that New York has granted to the foreign corporation. Thus, an inactive or dormant foreign corporation, even if it has qualified to do business in New York, is not subject even to a minimum tax if it is not doing any business in New York or doing only an interstate business.

Form 245 CT is required to be filed by foreign corporations not doing business in New York if they maintain officers or other representatives in New York, in an employer-employee relationship with a fair degree of regularity and continuity. The filing of this report enables the Tax Commission to determine on the basis of the New York activities of the foreign corporation whether or not it is subject to a franchise tax. The filing of Form 245 CT avoids possible penalties if the corporation is later held to be subject to a franchise tax.

Change in Classification

Article 160 of the 9A regulations provides that "A real estate corporation, more than 10% of the average gross

assets of which is invested during any year in securities, . . . becomes subject to tax under Article 9A on the first day of the following year." One of our members recently inquired of the Corporation Tax Bureau if a transfer of money from a commercial bank to a federal building and loan association would be construed as an investment coming under the 10 per cent rule.

The reply should be of considerable interest to real estate corporations. Cash invested in a federal building and loan association is considered by the Corporation Tax Bureau to be in the same category as cash in the bank. Accordingly, a real estate corporation may invest an unlimited amount of its funds in federal building and loan associations without losing its classification as a real estate corporation taxable under Section 182.

Another Aspect of Change in Classification

A real estate corporation purchases United States Government obligations in an amount less than 10 per cent of the average gross assets of the corporation. In a succeeding year the investment, though it is unchanged, does exceed 10 per cent of the average gross assets. Will that affect the classification of the corporation?

It would. Each year stands by itself. The average investments of a corporation during any year, including its investments in United States Government obligations, are compared to its average gross assets during that year. If such investments taken at their average market values exceed 10 per cent of the average value of gross assets during the year, the corporation becomes taxable under Article 9A on the first day of the following year. Reclassification can take place either because the investments have increased in value or there has been a decrease in the amount of gross assets.

Exercise of Stock Option

The Supreme Court (*LoBue*, 351 U. S. 243) had held that the exercise of a stock option at a price less than the fair market value of the stock was taxable compensation. The case had been remanded to the tax court for determination as to when the options were exercised.

The option was granted to the employee in January, 1945 to purchase stock if he was still employed on June 30. In May, 1945 he gave his unconditional promissory note payable in 1947 for the amount of the option purchase price. The taxpayer was given another option on January 1, 1946 to purchase 150 additional shares of stock. On January 3 he gave a promissory note for the option price. The notes were paid on May 24, 1946 and the taxpayer received the stock. The option price was less than the fair market value of the stock at all times and it was less when the notes were given than when they were paid.

The tax court held (28 T.C. No. 158) that the first option was exercised in 1945 when he gave his note, and the second option on January 3, 1946 when he issued the second note. The taxpayer received the economic benefits of the options when the notes were given. The notes were evidence of the exercise of the options.

The date of payment is not the relevant date. Under State law the result would be the same. Article 25 of the Regulations provides in part: "Compensation paid an employee of a corporation in its stock is to be treated as if the corporation sold the stock for its market value and paid the employee in cash." In the LoBue case the compensation would thus be the fair market value at the time the employee became entitled to the stock, less the payment made by him.

Accounting at the SEC

Conducted by Louis H. Rappaport, C.P.A.

Opening Inventories in Initial Examinations

In the December, 1957, issue of this magazine Charles L. Savage, CPA, raised an interesting question: "Is a CPA required to disclose the fact that he did not observe the taking of the inventory at the beginning of the fiscal year on which he is reporting?" Dr. Savage summarized the divided opinions on this question of Michigan CPAs who constitute the Michigan Society's Committee on Accounting Principles and Auditing Procedures.

The question is one which is particularly pertinent in SEC practice. When the owners of a closely-held business decide for various reasons to make a public offering of their holdings, the securities must first be registered with the SEC unless an exemption under the Securities Act is available. If the company's financial statements have been audited for several years by an independent public accountant whose examination conformed to generally accepted auditing standards, there will be few or no auditing problems in connection with preparing the registration statement. In the case of closely-held companies, however, their financial statements may have never been audited. Sometimes they may have been audited, but the accountant's examination may have been so limited in scope that he was not able to issue an unqualified report.

The financial statements and earnings summaries in a registration statement cover a period of years. In the usual case the three latest years of that period must be certified by independent accountants. If the accountant has never served the company before and is employed because of the need to register with the SEC, he may have a problem certifying an income statement covering, say, three separate years where opening and closing inventories are a material factor in the determination of net income. What, if any, references should be made in the accountant's certificate concerning the inventories of earlier years when the accountant did not observe the taking of such inventories?

Generally accepted auditing standards require the auditor to observe the taking of inventories and to confirm receivables where either of these assets represents a significant proportion of the current assets or of the total assets of a concern. Failure to apply these procedures, *where they are practicable and reasonable*, ordinarily precludes expression of an opinion by the accountant on the fairness of the financial statements taken as a whole. (In Statement on Auditing Procedure No. 26, however, it was stated that if the auditor does not apply the

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Louis H. Rappaport, C.P.A., *a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A.s, is the author of* SEC Accounting Practice and Procedure.

extended procedures but satisfies himself by other means, he should so state in the scope paragraph of his report, and no exception would be required in the opinion paragraph.) The inventory and confirmation procedures, it will be noted, must be *both* practicable and reasonable.

> . . . In the province of auditing, *practicable* means "capable of being done with the available means" or ". . . with reason or prudence"; *reasonable* means "sensible in the light of the surrounding circumstances." For example, the observation of physical inventories at the beginning of the period or year under examination would seldom, if ever, be practicable or reasonable in initial or "first" audits. However, the independent accountant must satisfy himself as to such inventories by appropriate methods.[1]

Whenever *ending* inventories are material and have not been physically observed by the auditor, he must qualify the *scope* section of his report (but not necessarily the *opinion* section of his report). There is no requirement to qualify the scope section of the report with respect to *opening* inventories.[2]

At first glance it would appear that different standards of auditing procedure apply to *opening* inventories than apply to *closing* inventories. Carman G. Blough, CPA, says, however, that is not quite the case:

> If the accountant has performed the observation and other necessary auditing procedures as of the end of the period, he has established an "anchor" or starting point from which in most cases he can get a perspective of the opening inventory. Lacking such a starting point, we are inclined to doubt that he could take responsibility for either the opening or the closing inventories in their relationship to the financial statements, except in the rare cases where other procedures can be employed in place of the observation procedures.[3]

The SEC recognizes that some auditing procedures commonly applicable in the examination of financial statements for the latest year for which a certified income statement is filed, such as the independent confirmation of accounts receivable or the observation of inventory-taking, are either impracticable or impossible to perform with respect to the financial statements of the earlier years and, hence, would not be considered applicable in the circumstances.[4]

To summarize, in an initial examination, if the accountant has been able to satisfy himself as to the amount of the inventories prior to his engagement, there is ordinarily no necessity for him to state in his report that he did not attend or observe the taking of physical inventories at dates prior to the balance sheet date. Although there is no necessity in these circumstances to refer to the earlier inventories, if, for some reason, the accountant does say something about them, he should make his position clear, that is, he should state generally what work he performed and indicate that he is satisfied.

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1. *Codification of Statements on Auditing Procedure* (1951), p. 21.
2. Ibid.
3. Carman G. Blough, CPA, *95 Journal of Accountancy 600* (1953). See also *Journal of Accountancy*, March 1956, p. 74.
4. Accounting Series Release No. 62 (1947).

Administration of a CPA Practice

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

| Relieving the Overburdened Practitioner . . . Systems and Human Beings.

Relieving the Overburdened Practitioner (Series 4)

A partner of a national firm submitted the following contribution concerning a policy which has been helpful to himself and to his firm. Smaller firms may find that this policy, or an adaptation of it, may well be helpful to them also.

"It is elementary that adequate staff is necessary to prevent principals of a firm from becoming overburdened. In order to insure that adequate staff would be available throughout the year, we found that long-range planning of assignments was a necessity. Semi-annually assignments are worked out on a weekly basis for the succeeding six months.

"Early in April we sketch out the principal assignments for the busy period, roughly January 1 through March 15. Then the July-December period is worked out as completely as possible. The schedule for the busy period will reveal the in-charge and principal assistant assignments which cannot be covered by the present staff and will at the same time furnish the names of those who will be required for interim work during the July-December period. In this way it is known well in advance in which weeks there is insufficient staff and in which a surplus exists. With this information at hand, steps can be taken to remedy the situation. Often, clients will consent to scheduling their work during a period when there is a surplus of staff and out of a period when there is a staff shortage. The detailed weekly assignment schedule for the January-June period is usually prepared prior to Labor Day.

"The time when the programming is to be done and the months to be included in each six-months period may depend upon the practice of a particular firm. We have found that our approach fits the needs of our practice.

"When a six-months assignment schedule has been prepared, the assignment schedules for each partner are prepared for the same period. A review of the individual partners' schedules may reveal the necessity for some rearrangements of partnership responsibilities.

"To further avoid overburdening individual partners and to provide for succession, we have a second partner

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MAX BLOCK, C.P.A. *(N. Y., Pa.), is a former chairman of the Committee on Administration of Accountant's Practice of the New York State Society of Certified Public Accountants. He is a lecturer at The City College of New York in the graduate course on Accounting Practice. Mr. Block is a member of the firm of Anchin, Block & Anchin.*

for each client. This frequently serves to provide partnership coverage in the event the primary partner is too busy, ill, or otherwise unavailable. We have found this system especially effective when the client requests special work during an inopportune time for the primary partner."

Systems and Human Beings

One of the most common management advisory services provided by accountants is the installation and improvement of systems. It is readily possible to develop theoretically excellent procedures but it happens, on occasion, that they just do not produce what is expected of them. The deficiency may not at all be in any of the technical aspects of the procedures but rather in their unacceptability to the clerks and other workers who are required to conform to, and carry out, the stipulated procedures.

A recent article[1] by a professor of accountancy, entitled "Cost Control is People," brings out forcefully that cost systems and budgetary controls must not overlook the human element—that success or failure depends on the cooperation and compliance of people, and the willingness of workers to produce at a maximum. The writer points out that people do not like to be controlled, or, as the "hidden persuaders" would call it, manipulated. They instinctively resent restriction and express their resentment in their daily output and attitudes.

Another noteworthy point developed is that some informality in the ways of doing things and working together is natural to people. Standard costs and budgets, being precise and formal methods of judging and measuring human performance, conflict with the variability of human nature and the desire for informality.

A number of measures are cited by the author to help bridge the gap between the nature of man and the demands of the formal organization. They include: (a) recognition of the human element problem in cost standards and budgets; (b) explanation of the cost control plan to workers and supervisors; (c) the participation of staff in the setting of standards, which should be reasonably attainable; (d) recognition of accomplishments as well as of failures; (e) specific training in human relations for those in charge of cost controls; and a number of other valuable ideas.

Another writer,[2] dealing with the subject of the individual worker, is most effective in describing the impact on men and women of specialization in work and their subjection to menial, simple, unchallenging work. Workers so affected are not highly productive, nor can they be creative and contribute to management suggestions and ideas that could be so helpful.

Management may expect workers to respond to incentives such as piece work or volume bonuses, yet often the response is not forthcoming. Fringe benefits are expected to produce loyalty and better-than-average productivity, yet the evidence of that accomplishment is not clearly forthcoming. The characteristics of the controls to which adults are subjected are often more suitable to infants than to adults, according to the author who is connected with the Department of Industrial Administration, Yale University.

This dilemma—the conflict between individual needs and organization demands—is a continuing fundamental problem with which employers must contend. Jobs should not be narrowed down too much, and increased employee participation in planning and decisions may be helpful in overcoming difficult personnel relations problems.

A businessman,[3] addressing a group of accountants on the subject of worker productivity, made some pointed observations, summarized as follows:

It was suggested that more emphasis be given the human side of worker efficiency. Noting that office automation has received a "science-fiction" buildup, he cautioned that, though effective, it is not the only means of getting the most out of payroll dollars. In spite of all the new business machinery sold or leased in the past decade, he pointed out that clerical help is more expensive and in shorter supply today than five years ago.

Calling for further effort to roll back the clerical cost frontier, he named monotony, boredom, fatigue and worker tension as four of the major factors siphoning off payroll dollars. Tension alone, he said, costs industry $3 billion each year in lost wages and in damage to workers and their machines. Specially designed work-music is useful to soothe nervous tension and relieve boredom and fatigue, and he cited studies to prove that it increased employee efficiency, and reduced boredom-related problems such as idle conversation, tardiness, day-dreaming and errors.

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1. Robert I. Dickey, "Cost Control is People," *Cost and Management*, May 1957, pp. 197-204.
2. Chris Arggis, "The Individual and Organization: Some Problems of Mutual Adjustment," *Administrative Science Quarterly*, June 1957, pp. 1-24.
3. Address of Joseph W. Roberts, Vice President—Marketing, Muzak Corporation, at a technical session of the Brooklyn Chapter of the National Association of Accountants, October 2, 1957.

Accountants' Reports on Plain Paper

Need there be any concern as to whether CPAs submit reports and financial statements on plain paper? Also, does the CPA have any responsibility regarding such data? We have seen that authority for plain paper presentations may exist, at least by inference, in official pronouncements of the American Institute. These same pronouncements might also seem to indicate that by submitting data on plain paper no rules or restrictions are applicable and consequently the CPA has a free hand. . . .

A client receiving an accountant's report on plain paper may have no hesitancy in presenting it to a credit grantor as having been prepared by his accountant. Indications are that this leads to confusion. However, our immediate problem is whether the CPA has any responsibility regarding such presentation. As outlined above, it might be logical to conclude that the CPA has no responsibility in these situations and possibly he should have none. Although many may argue the point, it is submitted that the CPA as a professional practitioner does have a responsibility to make a fair and not misleading accounting presentation to the extent of his knowledge of the facts in a given situation. Certainly, however, no one would be entitled to assume that figures presented in such financial statements on plain paper had been verified by the CPA.

Robert Caldwell, "Professional Responsibility For Non-Opinion Reports," PENNSYLVANIA CPA SPOKESMAN, November 1957

Payroll Tax Notes

Conducted by Samuel S. Ress

Recent Unemployment Insurance Decisions

Two significant decisions reversing determinations of the Industrial Commissioner and of considerable interest to New York employers and their accountants, were handed down recently. In one of the decisions, the referee held that New York clothing workers who were claiming unemployment insurance benefits last July during the annual vacation period provided for in the collective bargaining agreement between the union and the employers, were not entitled to the benefits. These benefits, which had been paid to them out of the unemployment insurance fund, were charged to the employers' individual experience rating accounts. The referee ordered that the $10 Hearing Deposits remitted by the employers who had requested hearings on this issue, were to be returned to them. The experience rating of those employers who had failed to request hearings on this issue will not be affected by this decision.

Samuel S. Ress, *an Associate Member of our Society since 1936, is a member of the New York and Massachusetts Bar. He is engaged in public practice in his own office in New York City specializing in payroll taxation and labor-management matters.*

Dr. Ress is a member of the Society's Committee on New York State Taxation and Chairman of its Subcommittee on Unemployment Insurance.

In case number 537-367-57R, decided November 27, 1957, involving the right of claimants to be eligible for unemployment insurance benefits during the vacation period, the referee had to dispose of a preliminary jurisdictional issue relating to the failure of the employers to make statutory deposits in each case. With respect to this issue the Referee stated:

> . . . With respect to those cases where an employer made a deposit in a single case, that is sufficient compliance with the statute with respect to all other former employees of the same employer where the facts and issues are identical. (Appeal Board No. 47,366-54; also 1951 Report of Joint Legislative Committee on Unemployment Insurance, Appendix B, pp. 32, 34 and 35.) . . .

In the foregoing decision, two of the issues which were supposed to be resolved by the enactment of legislation at the Special Session of the New York State Legislature last June, have been covered substantially by the referee's decision in the case above.

In a second case, the Unemployment Insurance Appeal Board relieved an employer from an unemployment insurance assessment retroactive to June of 1950. In this unusual case, number 60,157-57R, the Appeal Board granted an application by the employer, pursuant to Section 534 of the Unemployment Insurance Law, to reopen and reconsider the decision it had rendered in 1954, affirming the decision of a Referee who had sustained the Industrial Commissioner's determination assessing

the employer for contributions on the earnings of homeworker-typists. In the current case, the employer was operating a mail service business in connection with which he engaged typists to address envelopes for advertising materials from mailing lists furnished by the employer who in turn received them from the client.

At the hearing before the Appeal Board, additional testimony was offered by the employer establishing the fact that the typists worked at hours to suit their own convenience and that they were not subject to any supervision, direction or control by the employer as to the manner, method or means by which the work was to be performed. In reversing the determination of the Industrial Commissioner holding the employers subject to the Law effective June 19, 1950, the Appeal Board cited case number 50,217-55.

It should be noted that even though the homeworker-typists are not subject to the New York State Unemployment Insurance Law in the above situation, industrial homeworkers are considered employees for Federal Social Security and Federal Unemployment Taxes and the Federal Fair Labor Standards Act. Industrial homeworkers are considered employees under the New York State Unemployment Insurance Law.

In the case of *Arkay Junior Frocks*, 4 App. Div. 2nd 731, affirming Appeal Board case number 52,061-55, the Court found certain salesmen and assistants were employees and not independent contractors. The employer, a dress manufacturer, occupied same premises with two other dress manufacturing corporations. The stock of the three corporations were held by the members of one family. The three corporations executed agreements jointly with the salesmen involved. The agreement provided that the salesmen could not engage in any other business or be employed by any other person, and were to solicit orders at prices established by the corporations, the orders being subject to acceptance by one of the corporations with right reserved for refusal to accept the orders. The salesmen were required to travel at specific times in the territory designated by the corporation and sales were restricted to customers in the designated territory whether made on the road during six months of the year or in the salesrooms of the emplover during the other six months. The salesmen, in this action, paid no rent for the use of the salesrooms, but he did pay the salaries of assistants and a stenographer employed by him in his work. He also paid his own traveling, entertainment, stationery, and advertising expenses. Local telephone calls were paid by the firm and long distance calls were paid by the salesman, who was charged for samples and credited with them upon return. The salesman fixed his own itinerary and determined time and places of calls in the territory, and was appointed for a term of one year and paid on a commission basis.

It was held that the Appeal Board had found as a fact that the salesman and his assistants were employees of the employer. The Court could not reject the finding of fact made by the Board, despite certain indicia which appeared in the record of the hearing, from which it could equally be inferred that the salesman was either an independent contractor or an employee.

Federal Income Tax Notes

Conducted by RICHARD S. HELSTEIN, C.P.A.

Prunier Decision Reversed on Appeal . . . Transferee Liability for Life Insurance Proceeds . . . Change in Method of Depreciation . . . Contributions to Employee Welfare Plans . . . Business Expense . . . Exclusion of Death Benefits . . . Claims for Refund.

Prunier Decision Reversed on Appeal

Two brothers, controlling and dominant stockholders of a close corporation, were each the beneficiary of insurance policies on the other's life. A separate agreement provided that in the event of the death of either, the proceeds were to be turned over to the corporation for the purpose of redeeming the corporation's stock held by the deceased. The corporation paid the premiums but did not claim the payment as a deduction.

Holding that under Massachusetts law, the corporation was the beneficial owner of the policies, that it could have collected the proceeds in a "court of equity," and that it would be considered "contractually bound to apply the proceeds of the policies to buy out the interest of the deceased stockholder," the Circuit Court reversed and remanded the Tax Court's decision that the premium payments by the corporation constituted income to the stockholders. The Circuit Court stated, as was ruled in the *Casale* case (*Casale* v. *Com.* (CA-2, 1957) 247 F(2d) 440; NYCPA Vol. XXVII, No. 11, Nov. 1957, p. 790), that the separate entity of the corporation could not be ignored, and further, that the Tax Court's holding that a benefit to the corporation is a benefit to the stockholder is untenable (*Prunier et al* v. *Com.* CA-1, 11/8/57).

RICHARD S. HELSTEIN, C.P.A., *has been a member of our Society since 1940. He has been a member of the Committee on Federal Taxation, as well as various other committees. He is presently a member of the Committee on Publications.*

Mr. Helstein has contributed to accounting and other publications, and delivered addresses before our Society and other professional societies. He is associated with J. K. Lasser & Co.

Transferee Liability for Life Insurance Proceeds

In order to finally resolve the question of whether beneficiaries of life insurance policies are transferees, and to what extent they are liable for income taxes unpaid by the decedent at the time of the insured's death, the Supreme Court has granted certiorari in the cases of *USA* v. *Molly G. Bess* (CA-3, 1957) 243 F(2d) 675, and *Jean F. Stern* v. *Commissioner* (CA-6, 1957) 242 F(2d) 322.

The question is one which has been the subject of much litigation, and the courts have reached decisions which ran from the extreme of holding the entire proceeds taxable (as did the Tax Court in *Ruth Halle Rowen et al* (18 TC 874), reversed by CA-2, 1954 (215 F(2d) 641), through the gamut of holding that there was transferee liability only to the extent of the cash surrender value of the policies at the time of death (*USA* v. *Molly G. Bess*, supra; *Pearlman* v. *Com.* (CA-3, 1946) 153 F(2d) 560), to the other extreme that no part of the proceeds could be reached by the Government (*Jean F. Stern* v. *Com.*, supra).

The question is really dichotomous. In connection with the first part, it has been held that the *proceeds* of the policies were never the property of the decedent, since they came into being only upon his death. Thus, they could not have been assets of the decedent *transferred by him* (but, cf. *Kieferdorfer* v. *Com.* (CA-9, 1944) 142 F(2d) 723, cert. den., where the proceeds were paid to the decedent's estate and then distributed to the widow). However, the Second and Third Circuits have held that the cash surrender values of the policies were assets of the decedent, which, on his death, merged with the greater values i.e. the proceeds, and that therefore there was transferee liability to that extent (*Rowen* v. *Com.*, supra; *Pearlman* v. *Com.*, supra; *USA* v. *Molly G. Bess*, supra). The Sixth Circuit differed and held that upon death, the cash surrender value no longer exists, and that therefore there was no asset transferred which the Government could follow (*Stern* v. *Com.*, supra).

The second phase of the question is that of the import of the individual state's insurance laws in this question. In the *Rowen* case, despite the holding that there was a transfer to the extent of the cash surrender value of the policies, no amount was awarded to the government because New York law provides that beneficiaries are preferred as to creditors (except in cases of fraud, etc.).

A further theory has been raised by the U. S. District Court for the Southern District of New York (10/2/57) in the case of *Rose H. Jeromer* v. *U. S.*, where the Court avoided the problems raised by the *Rowen* decision (which was in its circuit) by following the decision of the Fifth Circuit in *USA* v. *Lynne Marx Gilmore* (CA-5, 1955) 222 F (2d) 167, and holding that there was liability by the beneficiary under Sec. 826(c) IRC 1939 (substantially the same as Sec. 2206, IRC 1954) to the extent of the pro rata share of estate tax attributable to the life insurance proceeds. Were the beneficiary to restore such amount to the estate, there would be sufficient funds in the estate to pay the income tax liability. Of course, this is an expedient which rather than solving the problem, avoids it, and, perhaps, adds an additional complication.

Change in Method of Depreciation

Where the declining-balance method (limited to 150 per cent of the straight-line rate) is used in the computation of depreciation on assets acquired prior to January 1, 1954, it is necessary to obtain permission of the Commissioner to change to the "straight-line" method (Rev. Rul. 57-510, IRB 1957-44, 15). This ruling follows up Rev. Rul. 57-352 (IRB 1957-31, 9) which was discussed in NYCPA, Vol. XXVII, No. 10, October 1957, page 718.

This, of course, does not apply to property acquired or constructed after December 31, 1953 on which depreciation is computed under the declining-balance method, since Sec. 167(e), IRC 1954 specifically reserves to the tax-

payer the right to change to the straight-line method at any time without the Commissioner's consent, if the taxpayer has not executed an agreement with the Commissioner as to the life of the assets and rate of depreciation under Sec. 167(d).

Contributions to Employee Welfare Plans

The Commissioner has revoked and modified, respectively, prior rulings P.S. No. 55 (January 9, 1946) and Mim. 5985, (46-1 CB 72) to now provide that where a trust, which forms part of an accrual basis taxpayer's pension, stock-bonus or profit-sharing plan, is qualified in all respects under local law on the last day of the taxable year except that the payment of corpus has not been made, if payment of corpus is made within the time prescribed by law for filing the return (see Sec. 404(a)(6) IRC 1954), the trust shall be deemed to have been in existence on the last day of the taxable year. Thus the contributions will be deductible under Sec. 404(a). (Rev. Rul. 57-419, IRB 1957-38, 11)

Business Expense

Where a corporate officer claims as a deduction travel or entertainment expenses which are *not* reimbursed to him by the corporation-employer, it is incumbent upon him to prove that such expenses are necessary to the earning of his remuneration. The Commissioner's explanation is that "a corporation and its officer are different entities" and "the statute does not permit the deduction by one taxpayer of the expenses of a separate and distinct taxpayer." However, if the officer receives an allowance, or there is a corporate resolution requiring him to assume such expenses, the Commissioner states that this would "tend to indicate that these are a necessary expense of his office." The absence of this evidence is not necessarily fatal, but does increase the taxpayer's burden of proof (Rev. Rul. 57-502, IRB 1957-43, 15).

Exclusion of Death Benefits

Where death benefits in excess of $5,000, in which the decedent employee had only a forfeitable interest, are paid in monthly installments, the $5,000 exclusion may not be pro-rated over the period of the installment payments. Instead, the entire amount of each installment should be excluded from gross income until a total sum of $5,000 has been excluded, after which the entire amount of each installment is includible in gross income. (Rev. Rul. 57-483, IRB 1957-43, 11)

However, where a portion of the death benefits paid are non-forfeitable, the installment payments must be pro-rated in the ratio that the forfeitable and non-forfeitable portions bear to the total to be paid. That portion of each installment attributable to the forfeitable amount is to be excluded from gross income until $5,000 is excluded. The part attributable to the vested interest is includible in full. (Rev. Rul. 55-64, 1955-1, CB 228)

Claims for Refund

The Commissioner has clarified Sec. 301.6402-3(a) of the Regulations on Procedure and Administration by explaining that the words "or an amended return" in the provision which states "in the case of income tax, claims for refund may not only be made on Form 843, but may also be made on Form 1040, Form 1040A, Form 1040B, Form 1040NB, Form 1040NB-a *or an amended return*," applies to amended Form 1120 (in the case of a corporation), or amended Form 1041 (in the case of an estate or a trust). (Rev. Rul. 57-501, IRB 1957-43, 36)

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